A3840-11.1 F 4/87

U.S. Chamber of Commerce Economic Policy Division

Policy Working Papers

March 1987 Number 1

Credit Card Wars Erupt Again

by
Rajni Bonnie Ohri
Economist

Although most interest rates have fallen substantially since the early 1980s, those on credit card debt have changed relatively little. This disparity has led to assertions that credit card interest rates are excessive in view of the decline in the funding costs of card issuers. As a result, several pieces of legislation have been introduced in Congress that would impose a nationwide ceiling on credit card interest rates.

Recently, a coalition of the country's largest consumer groups announced the launching of a nationwide campaign to lower credit card interest rates, catching the attention of both bankers and legislators. Ironically, the campaign begins at a time when many banks have already begun voluntarily to lower their rates. Nonetheless, the coalition is encouraging card holders to switch away from high-interest cards, to shop for better prices and services, and to seek legislative remedies in the area of disclosure and rate ceilings. This article focuses on the issues raised by the proposed federal limits on credit card rates, including the harmful effects of such ceilings on the availability of credit card services to different groups of consumers.

Consumer Groups Begin Battle

Consumer groups have stepped up pressure for banks to lower credit card interest rates, pushing for legislation that would impose a national ceiling on those rates. The temptation to impose federal limits stems from the recent U.S. experience with high interest rates. Such measures, however, are inappropriate because prices--in this case, interest rates--generated by the interaction of supply and demand in well-organized competitive markets, merely reflect an optimal adjustment of these forces to perceived economic circumstances, both present and future.

Last year, 22 states considered bills that would cap interest rates and at least seven actually enacted such limits. Usury ceilings were enacted in Connecticut (15 percent on retail and bank cards) and Rhode Island (18 percent), as well as in Iowa, Virginia, Wisconsin, and California. In addition, the Kansas legislature passed a measure banning annual fees and surcharges. Representatives of the consumer coalition insist that the caps encouraged price cutting, citing several banks in Connecticut that dropped their annual interest rates to levels below the ceiling.

Policy Working Papers are published by the Economic Policy Division of the U.S. Chamber of Commerce to inform the American public about relevant economic policy issues. These studies are intended as timely and thought-provoking contributions to the national debate about these issues which are of particular importance to the U.S. business community and the public at large. Permission is granted to quote from this report with appropriate attribution to the Economic Policy Division, Chamber of Commerce of the United States.

In their efforts to mandate relief for consumers, the proponents of usury ceilings must recognize that the distortions they create with their ceiling may entail costs that exceed those that they are trying to eliminate. Usury ceilings discourage lending and encourage borrowing. And because the demand for credit will now be greater than the available supply at the legal ceiling rate, lenders will ration their credit and naturally favor the most credit worthy customers. The result is that low- and moderate-income individuals and small, risky businesses obtain little or no credit. These persons have no recourse but to go without credit or else obtain it from illegal sources. Credit card interest rate ceilings will thus reverse the trend towards an increased availability of credit in the U.S.

In 1985, a study conducted by the American Bankers Association indicated that states that retained usury ceilings experienced a 17 percent drop in their share of the credit card market, while states that deregulated their ceilings showed a 13 percent gain. In Delaware, for example, laws deregulating credit card interest rates and allowing the establishment of special-purpose banks have attracted 34 new banks, creating over 8,000 new jobs for the state. Similar employment growth has occurred in credit card deregulated states such as Nebraska and South Dakota.

Consumer group representatives also claim that federal limits on interest rates are a step towards preventing lenders from exploiting unsuspecting borrowers. Although this is a legitimate goal, it is not clear that interest rate ceilings do anything to promote it. Consumers and inexperienced borrowers are adequately protected by truth-in-lending laws which require that the terms of credit be stated in clear, understandable language.

The most effective way to prevent exploitation in a market setting is to promote competition among sellers, especially price competition. By contrast, nonprice competition, to which usury ceilings lead, contributes to inefficiency and unfairness. Thus, usury laws in general are counterproductive because they restrict competition and encourage discrimination by lenders.

Are Banks Making an Unreasonable Profit?

Bank profitability is one issue that should be considered in evaluating the effect of any nationwide rate ceiling on credit card plans. Some advocates of credit card rate controls have suggested that profits on credit card plans are large enough to absorb the effects of finance rate restrictions without any substantial adverse impact on either the credit card rate services offered or the prices charged for those services.

According to a recent Functional Cost Analysis by the Federal Reserve Board, between 1972 and 1985, average net earnings before taxes on bank credit card plans were low, both in absolute terms and relative to returns on other major types of bank lending. During that period, the annual net earnings of bank card plans before taxes averaged 1.9 percent of balances outstanding. In comparison, net returns on other major types of commercial bank lending were higher on average than bank credit card earnings: 2.3 percent on real estate loans, 2.4 percent on consumer installment debt, and 2.8 percent on commercial and other loans.

However, there have been substantial year-to-year variations. For example, the average profitability of bank cards rose to 3.4 percent in 1984 and to 4 percent in 1985 (the peak for the 1972-85 period). In the late 1970s and early 1980s, when the cost of funds significantly surpassed any previously recorded highs, credit card rates, due in many cases to usury ceilings, were unable to rise in accordance with the cost of money. Yet, many institutions kept their portfolios despite losses during that period, while other providers sold their portfolios because they were a drain on bank performance.

Recently, favorable economic trends and structural changes in credit card regulation have helped reverse that downward trend. Although funding costs constitute a much lower proportion of total costs for credit card operations than for other major types of bank lending, the sharp decline in market interest rates has contributed to the recent improvement in credit card profits. In addition, the relaxation or removal of regulatory constraints on credit card interest rates in many states in the early 1980s has helped increase profits. These actions were taken after credit card issuers experienced a severe squeeze on profits in the 1979-81 period.

Another factor in the 1984-85 rise in bank card profitability was the major improvement in the quality of issuers' credit card portfolios following the economic disruptions of the late 1970s and early 1980s. Credit card issuers responded to falling profits by adopting much more selective credit standards in an effort to control costs. Also, many credit card accounts were terminated because of delinquencies and payment defaults. Thus, the remaining account holders were relatively good credit risks, causing delinquencies to fall to a historically low level in 1984. Growth in new credit card accounts has now slowed to less than 5 percent a year nationwide, down from a historical growth rate of 15 percent.

Annual data on earnings of retail credit card plans are not readily available. However, two national surveys of retailers were conducted on behalf of the National Retail Merchants Association in 1968 and 1985, and a study of retailers in New York was carried out in 1973. These studies indicate that, on average, such credit card plans consistently operated at a loss. Obviously, tighter credit card rate ceilings would simply exacerbate retailer losses.

Is the Market Competitive?

A critical issue in any discussion of price ceilings is whether the market involved is competitive. The diversity of credit card pricing schemes, the heavy volume of solicitations, and the pace of entry by new competitors seem inconsistent with a general absence of competition. The most notable, Sears, Roebuck and Company's Discover card is one new entrant posing a serious challenge to bank credit cards. Besides the banks, major corporations such as Amoco, J.C. Penny, Subaru, and a joint venture of

Household International and Comp-U-Card, the electronic shopping service, are offering credit cards as are most brokerage firms. And recently, many nonprofit groups have gotten into the act.

With over 15,000 card issuers in the nation, the credit card business is highly competitive. In 1986 there were over 731 million credit cards in the possession of consumers, of which 186 million were bank credit cards. The single largest credit card issuer, Sears, accounted for only 11 percent of all credit card balances outstanding at the end of 1985; the second largest, Citibank, accounted for only 5 percent (see Table 1).

Table 1

Credit Card Credit and Other Consumer Credit
September 1986

	Amount outstanding ($ Billions)	Percent of credit card credit	Percent of consumer credit
All Consumer Credit	584.9	--	100
Credit Card Credit	126.4	100	21.6
Bank card credit	80.6	63.8	13.8
Retail card credit	35.7	28.2	6.1
Other	10.2	8.1	1.7
Bank Credit Card Issuers			
Ten largest issuers	24.7	30.7	4.2
Citibank	6.36	5.0	1.0
Bank of America	4.75	3.8	0.8
Chase Manhattan	2.77	2.2	0.5
Manufacturers Bank	2.58	2.0	0.4
First of Chicago	2.15	1.7	0.4
Chemical Bank	1.61	1.3	0.3
Marine Midland	1.37	1.1	0.2
Wells Fargo	1.30	1.0	0.2
Maryland National	0.89	0.7	0.2
First Atlanta	0.81	0.6	0.1

Sources: Federal Reserve Bulletin, January 1987
The Nilson Report, No. 388 (September 1986) pp. 6-7

The largest 10 card issuers represented only 31 percent of credit card loans. These figures indicate that, even if credit card issuers faced no competition from other suppliers of consumer credit, they would face a high degree of competition from each other--more than enough to resolve concerns about excessive pricing. In such an environment, the marketplace is an accurate determinant of the value of the product. Any potential competitor who does not offer the appropriate value level for the cost of the product will be quickly abandoned for someone providing a better deal.

Credit cards must also compete with other forms of consumer credit from such lenders as finance companies, retailers, manufacturers, and other depository institutions that do not offer credit card plans. In many cases the substitutability of such other forms of credit is direct. For example, one may purchase a stereo system not only with a credit card but also with a loan from a finance company or on direct credit from the retailer. Virtually all consumer products can be purchased on credit, yet only 20 percent of purchasing is, in fact, made on credit card credit. Thus, consumers have ample opportunities for shifting their "debt portfolios" from one category of spending to another in response to different "prices" for different categories of credit.

Competition has forced interest rate charges down. In mid-January, Citicorp cut the rate it charges on its premium cards to 16.8 percent from 19.8 percent. And Manufacturers Hanover Trust cut its interest rate on Visa and MasterCard accounts to 17.8 percent from 19.8 percent. Also, Sears is marketing its Discover card without an annual fee and a rebate of up to one percent on all charges. Other big issuers have begun to offer floating rates (tied to Treasury bills or other financial indices) that are lower than the prevailing fixed rates. If markets were uncompetitive, there would be no incentive for card issuers to cut their rates or eliminate their annual fees. Nor would there be a significant barrier to retailers assessing an annual fee. It is important to recognize that the disclosed rate is not the only element of competition. Focusing on the interest rate overlooks the variety of other services provided by credit cards as well as the variety of pricing systems. Competition is prompting some issuers to offer a diversity of services such as discount bus fares, termite inspections, long distance calls, and vacations.

Credit Cards on the Rise

Despite the high credit card interest rates in many states, consumers are pulling out their plastic more than ever. Since 1980, the combined number of cardholders for Visa and MasterCard has doubled to more than 255 million. According to a survey by Bankcard Holders of America, over 25 percent of cardholders used their cards more frequently in 1985 than in 1984; 40 percent charged items at least once a week; and three out of four paid 18 percent or more on their outstanding monthly balances.

Indeed, credit card debt has expanded rapidly in the last three years--a sign that consumers view credit card use as a desirable source of short-term financing despite what many observers regard as high interest rates. Industry experts insist that interest rates are not the determining factor in consumer acceptance. Most doubt that even the new tax law, which eliminates the deduction for consumer interest and thus makes credit more expensive in after-tax dollars, will have much impact. Essentially, the convenience value of credit cards is so high that people are willing to pay the price. But convenience is not without its costs. In order to provide this unsecured, flexible credit, the bank card industry has invested heavily to develop sophisticated and costly telecommunications systems which are unique to this type of consumer credit.

The Cost of Funds

Many have argued that since market interest rates have fallen across the board, then credit card rates should decline by the same magnitude. However, the cost of funds represents only a portion of the total costs of revolving credit. Data from the Functional Cost Analysis show that only 42 percent of the total costs of providing bank card services consists of the cost of funds. Credit processing, debt collection, loan losses, and numerous other administrative costs are an important component of the charge. Because many of these costs vary only slightly with the size of the loan, these costs, which are included in the finance charge, must be proportionally higher for smaller loans.

The Cost of Bad Credit

What is especially worrisome to many bankers and other card issuers is the rising tide of both fraud and personal bankruptcies that is pushing up loan losses on credit card accounts. This year, many bankers are writing off nearly 11 percent of their credit card debt as uncollectible (see Table 2).

Table 2

Credit Quality
(Second Quarter 1986)

	Amount Charged ($ Billions)	Percent Written Off*
Citibank (South Dakota)	8.2	10.8
BankAmerica	5.2	5.7
Wells Fargo	4.0	4.1
Chase Manhattan USA	3.6	10.8
First Chicago	3.3	7.0
Citibank (Nevada)	2.0	4.5
Manufacturers Hanover	1.8	4.8
Citibank (New York)	1.5	1.9
Chemical	1.3	6.0
Marine Midland	1.3	6.6
Security Pacific	1.1	6.2
Maryland National Bank	1.1	3.5
Beneficial National Bank	1.0	10.8

*Annual rate of net charge-offs as uncollectible in second quarter of 1986.

Source: Veribanc, Inc.
Businessweek, November 17, 1986

The depressed economy in the farm belt and problems in the energy sector of the nation are causing losses in regional banks' card loan portfolio. In the year ending September 30, 1986, personal bankruptcies numbered nearly 430,000, up 37 percent compared to a year earlier.

As unsecured lenders, credit card operations recover little or nothing of their outstanding loans in a bankruptcy case. When bankruptcies increase as a percentage of total credit losses, recoveries on these losses decline, and this lowers bank earnings. Although bankruptcies have traditionally accounted for 10 percent of credit card losses at bank card operations, today they represent as much as 40 percent of such losses.

Fraud is also a major problem and losses from it are estimated at $80 million a year according to the American Bankers Association. This represents over one percent of all credit card charges. These losses have encouraged the industry to devote substantial resources to developing a card that is more difficult to alter.

Bank card industry losses since 1970 have fluctuated between 2 percent and 4 percent of credit outstanding. At the end of 1985 they were between 3 and 3.5 percent; and credit card defaults in 1986 are expected to rise to 4.2 percent of charges outstanding.

Thus, bankers argue that taking into consideration fraud losses, coupled with high default rates among charge card users, credit card interest rates are at a level consistent with the costs of supplying such credit to the consumer. Looked at it this way, credit cards are essentially a loan vehicle with very high administrative costs and large fraud and default risks, and the interest rate charged on such unsecured credit must cover these costs.

Economic Effects of Usury Ceilings

Any legislation which would restrict the ability to compete freely would hurt consumers by restricting the availability of a valuable array of services. Faced with a rate ceiling in a competitive market, banks must find some method of offsetting the revenue loss from such a constraint. A likely effect of such a ceiling would be to decrease the supply of credit cards, forcing card issuers to find other ways of reducing costs and raising revenues.

One obvious cost-cutting step that credit card issuers might take is to tighten credit standards so as to reduce the number and the cost of bad debts. As a result, low- and moderate-income borrowers would be denied credit cards as the issuers limited their customers to those that were financially secure. Holders of existing accounts could also be affected by more stringent enforcement of credit limits and by likely increases in minimum payment requirements.

In addition, financial institutions may curtail other services offered with the credit cards. Such features include protection programs that indemnify credit card holders for charges made with lost or stolen credit cards, rebates on purchases billed to a credit card account and provisions of emergency cash to travelers. If the pressure on profits becomes severe, some institutions may eliminate their credit card plans and retail firms may discontinue in-house plans, with the result that customers would need to rely on a shrinking base of suppliers. Such actions might lead to a concentration of cards in the hands of fewer issuers. Although elimination of credit card operations may seem like an extreme measure, some retailers and financial institutions did discontinue credit card services in the early 1980s in an effort to stem losses.

Another way of offsetting reduced interest income is to shorten or eliminate the grace period that credit card issuers typically allow, and to raise annual fees. In 1985, over 70 percent of commercial banks charged an annual fee for MasterCard and Visa accounts. Charges of this kind would affect all cardholders. Revenues could also be raised if a fee for each transaction were charged by card issuers. As of 1985, only 3 percent of the MasterCard and Visa issuers charged such usage fees. Banks and retailers might also establish or increase fees for processing credit card applications, for replacing lost cards and for issuing monthly statements.

Raising the merchant discounts (the fee banks charge merchants for processing credit card sales) represents still another way of increasing revenues. Increases in merchant discounts will affect both retailers and their customers, including those that do not use credit cards. The lower the volume of business and the lower the average sales ticket, the higher will be the merchant discount.

A final effect of a national usury ceiling on credit card rates would be increased segmentation of credit markets, both by type and geography. A 1981 study by the Credit Research Center observed that interest rate ceilings reduced competition between types of credit as card issuers would tend to specialize in lower credit risks, leaving higher credit risks to a smaller set of emaining sources such as finance companies. In addition, the emergence of numerous national bank cards, especially following the wave of state usury deregulation in the early 1980s, has had a substantial effect in making credit markets more competitive, especially in smaller communities.

The 1981 study also surveyed consumers and creditors in four states with different interest rate ceilings. The findings suggest that effective ceilings on credit card interest rates are more likely to result in reduced availability of bank credit card accounts for low- and middle-income families. The study also provides evidence that product prices might rise if a federally mandated ceiling on credit card rates were adopted. Bank credit card issuers in Arkansas were found to charge retailers merchant discount fees higher than those charged in the states with less restrictive rate ceilings. As with other costs, retailers offset these higher fees by raising product prices. Thus, as expected, cash customers subsidized credit customers. Indeed, major appliances were found to cost about 3 to 8 percent more in Arkansas--nearly 5 percent more on average--than in neighboring states.

Several recent studies show that the supply of bank card credit is, in fact, competitive, that usury ceilings injure consumers by contracting credit availability, and that unregulated credit has grown more rapidly than regulated credit. A 1985 study by Lexicon Incorporated reveals that revolving credit issued by banks in states with no credit card interest rate controls has grown more than twice as fast as credit from banks in states with rate controls. For example, Arkansas (limits credit card rates to 5 percentage points above the Federal Reserve Board's discount rate) was near the bottom for all states--revolving credit issued by Arkansas banks declined in real terms between 1980 and 1985.

Conclusion

The available evidence confirms the predictions of economic theory regarding the adverse effects of interest rate ceilings. The record of credit card profitability since 1972 suggests that restrictive rate ceilings such as those proposed by various consumer groups and legislators would create intense pressures to reduce the supply of credit and lead to inefficient, discriminatory nonprice credit rationing. These distortions impose enormous costs on the economy and discriminate against low-income borrowers and small businesses who are forced to go without credit.

A3740-11.2F

4/87

U.S. Chamber of Commerce
Economic Policy Division

Policy Working Papers

April 1987
Number 2

Is Inflation Really Dead?

by
David I. Meiselman
Director, Graduate Economics Program
Virginia Polytechnic Institute and State University

There have been widespread assertions that inflation is dead. Indeed, many analysts have gone further, contending that we are in a period of deflation. But is inflation really dead?

On one level, if we look back only to 1986 the answer is easy. Inflation has been dead, or close to it, since early in 1986. If inflation is defined as what happens to the general cost of living, say, as measured by the Consumer Price Index (CPI), we find that the index was almost unchanged in 1986, increasing by only about 1% for the year as a whole. The Producer Price Index (PPI), in fact, declined by nearly 3%, giving us some evidence of deflation. A leading actor in the 1986 inflation drama, but by no means the entire cast and script, was the sharp fall in the price of oil during the first half of the year, a price decline that has come to an end, at least for the time being. However, prices of the other components of the Consumer Price Index, including food, but especially services, continue to rise. Only in energy and energy related areas have there been significant price declines or stable prices.

The actual decline in these broad price indexes over much of 1986 may have been the first time this has happened in the lifetimes of some of you. The last time the Consumer Price Index actually fell over the span of a year was in 1949. That temporary price decline was the only interruption in a half century of continuous, uninterrupted inflation that started in the 1930s in the United States, and in virtually every other country in the world. This duration and degree of inflation was unprecedented in the prior 150 years of the 200-year history of the United States, or the 350-plus years if we start with the first English settlements in North America.

In fact, before the current era of inflation started, the price level was close to where it had been when the Declaration of Independence was signed in 1776 and for much of the 1800s. A thumbnail sketch of the inflation history of the United States before the 1930s watershed shows that there was significant inflation only surrounding periods of war. These were offset by periods of deflation after the wars ended that lasted until prices returned to their original levels. This meant that during peacetime years prices trended down. Peacetime deflation was the general norm. So, all in

Policy Working Papers are published by the Economic Policy Division of the U.S. Chamber of Commerce to inform the American public about relevant economic policy issues. These studies are intended as timely and thought-provoking contributions to the national debate about these issues which are of particular importance to the U.S. business community and the public at large. Permission is granted to quote from this report with appropriate attribution to the Economic Policy Division, Chamber of Commerce of the United States.

all, there was no clear tendency for money to lose its value over the lifetime of the typical American and similarly for his bonds, his insurance, his pensions, and the like.

But the old days of secularly stable purchasing power of the dollar ended in the 1930s. To be sure, the upward tilt of the Consumer and Producer Price Indexes, and such other aggregate measures as the GNP deflator, over the past half century, have not been steady and not all prices have been rising continuously. During the past 40 years, since the end of World War II, there have been varying waves of general trends of overall prices, from the 1% to 2% upward drift of the CPI during the first half of the 1960s, to the double-digit increases of 1973 and 1974 and of 1979 to 1981.

Even holding aside special circumstances for specific products which can buck the overall trend (for instance, because of crop failures, changes in government policies, wars, and the like), there are several general regularities worth mentioning, especially about the overall price performance in commodities markets in relation to such broad indexes as the CPI.

First, during periods of low inflation (as measured by the CPI or the GNP deflator), for example, the 1% to 2% per year upward drift from the late 1950s to the mid-1960s, the averages of commodity prices and of many indexes of sensitive prices trended down while consumer prices and wholesale prices drifted up.

Second, when inflation cools off, especially after a period of overheating, (as we experienced starting in 1982 following the double-digit increases in inflation of 1979 and much of 1981), the CPI may be rising, albeit at a slower pace, but sensitive commodity prices may tumble. The price decline, in part, is a reaction to the excesses and dashed expectations of the earlier rapid inflation.

Third, when inflation heats up, commodity prices rise dramatically, and volatility increases as well. For example, in late 1971 the futures price index of the Commodity Research Bureau was at 1967 levels despite an 18% rise in the Consumer Price Index in the 4 years between 1967 and 1971. One year later, by year-end 1972, the commodity price index increased by 35%. By mid-1973, before the oil price explosion that started in October 1973, the commodity price index hit 220% of the 1967 average. By contrast, over the same 1967-1973 period, the CPI increased by "only" 23.8%.

Fourth, when inflation heats up, not only do commodity prices increase faster than the general price indexes for final products (such as the CPI and the GNP deflator), and the price indexes for intermediate products (such as the Producer Price Index), but commodity prices in both futures markets and spot markets become more volatile. There is a similar increase in volatility of financial instrument futures. Increased volatility and the associated rise in uncertainty play havoc with many market participants. But this economic cloud has a silver lining since increased volatility and uncertainty enhance opportunities for profitable trading.

The era of secularly stable purchasing power of the dollar ended in the 1930s as a result of a series of permanent changes in the old arrangements, especially in the area of monetary affairs. Inflation is a reduction in the value of money, a fall in the purchasing power of each dollar. It is not surprising that the value of money, like the value of other assets, is related to its supply. The greater the supply, the lower the value. Hence, the greater the supply of money, the lower the value of money, which is to say, the more inflation. These average relationships of money to inflation take time to work themselves out. There are significant lags and inertia in the process.

When the U.S. monetary system was on a gold-linked money standard, the link to gold constrained the printing press and the supply of dollars. A dollar was "as good as gold" and "worth its weight in gold," approximately 1/20 of an ounce of it, because the price of gold was pegged at $20.67 an ounce. Given the link to gold, any spurt of inflation had to be temporary, to be reigned in by the monetary mechanics of the permanent link to gold and to fixed exchange rates that provided the framework of monetary discipline. To be sure, the discipline sometimes gave us other problems, but it did avoid serious inflation.

During the Roosevelt New Deal years, the link to gold was weakened, and then finally abandoned altogether in 1971. Fixed exchange rates were also abandoned as was the gold cover for currency, and similarly, the link to silver was dropped, including silver certificate currency. Essentially, every other vestige of monetary constraint or discipline has disappeared. Now, the Fed, acting on its own or at the behest of the White House or the Congress or whomever, can use its printing press as it wishes. There are no checks on all those monetary balances the Fed can create out of thin air. If you want to dignify this by calling it a standard, it has to be classified as a pure paper standard, sometimes called a fiat standard. There has never been an unconstrained paper standard that has not led to significant monetary abuses and inflation. To label this monetary chaos a standard or system is the economic oxymoron of the century! It is well to recall the words of the great economist, Ludwig von Mises, who wrote, "Government is the only institution that can take a valuable commodity like paper, and make it worthless by applying ink."

The same general story is also true for other countries.

While constraints on money creation were systematically weakened and then eliminated entirely, incentives increased to use the printing press to achieve economic and political objectives--including using money creation to control interest rates, to paper over other financial and banking problems, to finance government spending programs used to buy votes, or to pay for budget deficits. Printing money to pay the bills, at least in the short-run, i.e., before the next election, is often easier than raising and collecting taxes or selling bonds. Richard Nixon's 1972 success in pressing, or inducing into use, the Fed's printing press to influence pre-election economic and financial conditions, a pattern I have labeled, "The Political Monetary Cycle,"* was neither the first nor the last episode where an acquiescent or enthusiastic Fed helped out the White House. Recall that double-digit money growth before the 1972 election led to double-digit inflation in 1973 and 1974, which began before the OPEC oil embargo and price increase that compounded the problem.

---

*"The Political Monetary Cycle," Wall Street Journal, January 10, 1987, and "Is There a Political Monetary Cycle?" Cato Journal, Vol. 6, Number 2 (Fall 1986).

These factors have been strengthened enormously by the widespread belief that governments not only have the viable option to use monetary and fiscal policies, particularly expansionary policies, to produce prosperity and full employment in the short-run, but that governments have an obligation to do so. Indeed, not only did a generation of Keynesians and others believe and teach that fine tuning was possible and relatively simple to achieve, they also held that fine tuning was necessary to avoid or moderate business cycles caused by an unstable private sector.

To be sure, while there may be some temporary gains from excess stimulation, this will be at the later cost of both more inflation and higher unemployment than existed before the messy process started. It turns out that when there are marked changes in the growth of money, real effects are felt first and inflationary effects are felt later. Thus, following fast money growth comes the initial good news of more output and employment before the later bad news of more inflation, as the initial real gains in jobs are eroded and replaced by higher prices. For the opposite side of the coin, when there is a restrictive monetary policy, the initial effects are a reduction in output and employment; the secondary effect is a slowdown in inflation. For restrictive or anti-inflationary monetary policies, the bad news comes first and the good news follows. We have never been able to step on the monetary brakes to cure or moderate inflation without causing a recession.

All in all, the inevitable result has been a strong, persistent inflationary bias since the 1930s. When inflation gets out of control, governments step on the brakes, but only temporarily. When memories of past inflation woes dim, as now, vigilance relaxes, enhancing the possibility of short-run gains from starting up the inflationary process anew and thereby also increasing the probabilities of more inflation.

The general monetary environment is, in my judgment, central to the analysis of the general long-period inflationary environment. Within shorter periods of time, even over a year or two, inflation may not precisely track monetary change. The stock of money mainly affects total demand, and there can be short-period changes in the supplies of goods, including changes in the trade balance, or inertia, or changes in expectations, or in the various kinds of uncertainties and contractual arrangements that may temporarily cause changes in money not to be followed quickly and dependably by corresponding changes in prices in the short run. But these short-period deviations from long-period trends typically blur the main underlying inflationary forces, just as movements of the waves temporarily cause the level of the ocean to rise and fall, blurring the overriding effect of the tides. To be sure, short-term traders have to reckon with the waves, but traders can profit handsomely from the tides or be swamped by them. Indeed, even short-term traders ignore the tides at their great peril.

Given these general factors, we have to ask ourselves whether, despite a slowing or even an elimination of inflation in recent months, there is anything fundamental that has been altered in the framework I have sketched. Despite all the talk about a Reagan Revolution and all the self-congratulation about beating back inflation, it seems to me that there has been no permanent or enduring change in those institutional defects that can contribute to inflation. No constraints have been put on the Fed or on the whole printing press apparatus, nor have there been any changes in the incentives to use inflation for short-run political advantage. Indeed, as we get closer to the 1988 presidential election, there will be a greater payoff to the party in power from making employment and markets look better, even if temporarily, in order to keep the party in control of the White House. With the same constraints (or lack of them), the same incentives, the same institutions, and largely the same players, the probability is high that we will get the same general inflation results, which is to say, significantly more inflation than the experience of 1986. In retrospect, 1986 is likely to look like the temporary interruption in inflation that we previously experienced in 1949 rather than the start of a new noninflationary era. It's tough to get a sustained, significant effect without a significant cause.

There are several factors that increase the near-term prospects for inflation. First, the effect of the oil price decline is temporary and appears to be over. Moreover, another $15 a barrel decline would give oil close to a zero or negative price--hardly likely. Even another $15 cut would be a one-shot event, not a continuous process. Indeed, we cannot exactly count on an oil price decline of $15 a barrel every year. The "generous" Saudis are not about to pay us to take their oil! Moreover, even the rich Saudis would soon run out of cash to subsidize the unlikely process.

To place the oil price decline in context, it is useful to note that energy commodities account for only 6.8% of the weight of all the goods and services in the Consumer Price Index. So, as a first approximation, if all energy were free and nothing else changed, there would only be a once and for all decline in consumer prices of 6.8%, after which the inflation drama would continue playing itself out as before. Moreover, food, including restaurant meals and prepared foods, accounts for 18.5% of the CPI. Omitting food and energy (and energy services), the rest of the CPI, that is, 70% of it, has been rising between 4.5% and 5% per year since 1982, hardly an end to inflation, especially when at a "mere" 5% per year prices double in 14 years!

Even if Republicans had retained control of the Senate, the same general inflation incentives would have prevailed. Indeed, the incentives and opportunities to create inflation are present regardless of who controls the White House, which is why we have had close to similar inflation performance by both parties; double-digit inflation under both Republican Nixon and Democrat Carter, and very low or essentially no inflation under Democrat Kennedy and in the first few years under Lyndon Johnson as well as under Republican Reagan. There are some differences in inflation between the two parties in the first two years of their administrations, but little in the last two years.

Second, consider the preparations for the 1988 presidential election. With Democrats now in control of the Senate, they are better able to carp at a besieged Republican White House. Thus, there is likely to be even greater pressure on the Fed to produce economic and financial magic before November,

1988. When decisions are made, errors will surely be committed on the side of monetary ease, not tightness.

Third, the sluggish, lagged response of inflation to changes in the monetary aggregates saw double-digit inflation continuing after the Fed stepped on the monetary brakes in 1974 and, more recently, in 1981. Now we see the opposite side of the same coin. Over the past year, the M1 measure of money has been rocketing up at 17% to 18% per year making a sham of the M1 target and producing no inflation, as yet. The Fed has dropped all pretense by simply abandoning the M1 target.

Thus, the question which lingers in my mind is the following: Do you kno any responsible or knowledgeable person, whose judgment you respect, who would sign his name to the notion that continued 17% M1 growth would not re-ignite inflation? I find it very troublesome that, despite a few quiet questions and murmurs, there is virtually no effective Administration voice, rather muscle, behind any effort or move to slow money growth significantly. If we wait until actual inflation speeds up to slow down the printing press, it will be too late, especially as we get closer to 1988.

Fourth, the trade deficit, which I view as a minor problem at most, is widely viewed as a serious issue. Please note that if the statistics were not gathered and put in their current, largely irrelevant form--irrelevant, that is, for a floating rate world--we would be blissfully unaware that the so-called "trade deficit" exists! Given the wonders of double-entry bookkeeping, the trade deficit of over $150 billion is exactly matched by $150 billion of other surplus items in the accounting statement, especially a huge capital inflow from abroad. It is as if foreigners save a larger fraction of their incomes than Americans, use the savings to buy U.S. stocks, bonds and real estate, and also to put up automobile factories in Tennessee, and the like. Foreign savers and investors buy U.S. capital because American capital assets are secure, productive, and profitable--surely this is not a problem. Indeed, for much of U.S. history there has been a similar capital inflow to the United States, increasing the economic welfare of U.S. citizens and of foreign investors as well. Moreover, by increasing the capital stock in the United States, the general level of real wages also ends up higher, not lower, as the misguided protectionists incorrectly assert.

The mirror image of the net foreign savings flow to the United States, the capital surplus, is a corresponding net flow of foreign produced goods and services to the United States, the trade deficit. For those who feel uneasy about deficits, including trade deficits, perhaps we could relieve the angst by referring to capital surpluses, instead.

One effect of the capital surplus (trade deficit) is that we now have about 4% to 5% more goods per year in the United States than without it. So, the inflation rate is about 4% to 5% lower than it would otherwise be. By the same token, interest rates are also lower and securities prices are higher than they would otherwise be. Eliminating the trade deficit, either through fiddling around with foreign exchange markets or by use of trade restrictions, would tend to cause higher prices and higher interest rates, both because of the direct effect of the reduced capital inflow as well as the interest impact of higher inflation. In any event, these would add to inflation and to the impact of inflation on financial and commodities markets.

The good news is that there seems little chance of an immediate significant reduction in the trade deficit as long as foreigners see merit in investing in the United States because business prospects remain good, and the United States remains a safe haven. The greater danger is that the U.S. will be stampeded into adopting protectionist measures which will surely result in more inflation, higher interest rates and a lower standard of living in the United States.

To sum up, yes, there has been little or no inflation over the past year. No, inflation is not dead, only stopped temporarily. And the main reason inflation is not dead is that essentially none of the major determinants of inflation is much different and none has been permanently changed, despite claims of a Reagan Revolution and despite actual success in 1986. We have been here before, and as the slogan carved in stone on the National Archives Building in Washington says, "What's Past is Prologue."

I have no firm forecast of when the resurgence in inflation will become evident, except that I believe that the standard forecast of 3% inflation for 1987 is likely to be on the low side. For the CPI a safe bet is closer to 5% for 1987, with some chance it may be running even higher by the end of the year--which should be an opportunity as well as a warning!

A3840-11.3 F

4/87

U.S. Chamber of Commerce Economic Policy Division

Policy Working Papers

April 1987 Number 3

Raising the Minimum Wage and Derailing the Great American Jobs Machine

by
Graciela Testa-Ortiz
Director, Forecasting Section

Despite the more than eleven million jobs created since 1982, there is a concerted effort afoot to portray the past four years as a period of decline and harship for U.S. workers, and their future as exceedingly bleak. Through an expensive television advertising campaign, organized labor has identified the source of this misery as low-paying service sector jobs. The message is that, in order to avoid a dismal future, we must instruct our elected representatives to "do something" to turn around the trend towards low-paying jobs. That "something" is defined as raising the minimum wage. But as this study will show, raising the minimum wage will reduce employment and increase inflation.

A Political Agenda

The premise--that the newly created service sector jobs are low-paying, dead-end jobs--is false. Nevertheless, it is the basis of a political agenda designed to portray its advocates as patriotic, compassionate Americans dedicated to protecting the besieged American worker. The empirical and historical evidence, however, show that the solution being proposed--raising the minimum wage--will result in lower employment and higher prices. It is, however, likely to preserve union jobs and protect union earnings at the expense of everyone else.

The drive towards raising the federal minimum wage derives some of its support from the notion that the increase in employment of the past four years has been concentrated in low-paying, dead-end service sector jobs. This allegation is found in a recent and well publicized study for the Joint Economic Committee of Congress by Barry Bluestone and Bennett Harrison, which purports to show an alarming increase in low-paying jobs during the period 1979-1984. According to the authors, "...nearly three fifths of the net new employment generated between 1979 and 1984 was low wage, compared to less than one fifth during the preceding period [1973-79]." 1/

But, as economics writer Warren T. Brookes has since discovered, their analysis contains serious errors of which the authors were aware. Bluestone

Policy Working Papers are published by the Economic Policy Division of the U.S. Chamber of Commerce to inform the American public about relevant economic policy issues. These studies are intended as timely and thought-provoking contributions to the national debate about these issues which are of particular importance to the U.S. business community and the public at large. Permission is granted to quote from this report with appropriate attribution to the Economic Policy Division, Chamber of Commerce of the United States.

and Harrison arrived at inflation-adjusted wages by using the consumer price index (CPI) as a "deflator." However, the use of the CPI as an adjustment factor understates constant dollar wage scales. When the data was adjusted for inflation using the deflator for personal consumption expenditures as an adjustment factor, "...most of the low-pay trend disappeared." 2/ Another statistical error was the choice of years. Bluestone and Harrison arrived at their conclusion by comparing the period 1973-79 to 1979-84. This choice amounts to a comparison of two extremes and essentially credits Reagan with Carter's worst two years. JEC economist Christopher Frenze found that, if instead of comparing the years 1973-79 to 1979-84, we look at the data for the entire period 1973-85, "...there is almost no change in the distribution of jobs by pay classification, even accepting the Bluestone-Harrison data base with its disputed deflator." 3/

The Bluestone-Harrison study was intended to discredit the Reagan Administration's economic success. However, as Mr. Brookes points out, the years 1979-84 contain "...three Carter fiscal years that also included two recessions, the worst inflation in modern history and a massive...decline...in average real wages." 4/ But if the data is arranged to match each of the four-year presidential budget cycles, the numbers show just the opposite, namely, that during the Reagan years (1981-1985) the proportion of net new jobs created in the high-paying category ($28,048 and over) was 46 percent, compared to a 10 percent loss of such jobs during the Carter years, and a 6 percent loss during the 1979-84 period studied by Bluestone and Harrison. Moreover, the respective shares of low-paying jobs created were 6 percent during the Reagan years, 42 percent during the Carter years, and 58 percent in 1979-84. 5/ Contrary to what is implied by the Bluestone-Harrison study, the only conclusion that stems from the data is that the overwhelming majority--92.3 percent--of the net new jobs created during the Reagan Administration were in the middle- and high-paying categories.

Despite the fact that the allegations regarding the trend towards low-paying jobs have been shown to be wrong, they have become the basis for proposals to increase the statutory federal minimum wage in an effort to alleviate poverty and raise the standard of living of low-wage earners. This proposal is the economic equivalent of cutting off one's nose to spite one's face--a higher minimum wage reduces employment and increases inflation, leaving everyone worse off in the process. Increases in the federal minimum wage will especially hurt those vulnerable, unskilled workers who are priced out of the market and cannot find jobs at the higher minimum wage.

Oddly, the proponenets of raising the minimum wage couch their argument in welfare terms, insisting that since the last time it was increased, the minimum wage has been eroded by inflation, and that it has not kept pace wih increases in average hourly earnings in other sectors. This is indeed true. However, before deciding that raising the minimum wage will reduce poverty and raise living standards, it must first be establish who the minimum wage earners are.

Minimum Wage Earners Are Not Poor

The main thrust of the argument for raising the minimum wage is that doing so will raise earnings of low-income workers and reduce poverty. This reasoning, however, completely ignores the fact that only one-fifth of all minimum wage workers are classified as living below the poverty line. Moreover, more than 89 percent of the households below the poverty line would not see any change in their status if the minimum wage were increased. While this assertion may be surprising, it follows from what we know of the characteristics of minimum wage workers; namely, their youth and inexperience: 60 percent of minimum wage earners are under twenty-five years of age. In addition, two-thirds of them are part-time workers. Most minimum wage workers are teenagers who belong to households with an employed adult and income above the poverty line. In many instances, they are second or even third earners in the household. To those young, inexperienced workers, minimum wage jobs are an extension of schooling since those jobs offer them the training and the work experience to move on to higher paying jobs. The minimum wage deprives the youth of America, not only of the opportunity to get a job, but also of the needed experience and on-the-job training, while it does nothing to alleviate poverty.

Indeed, the major problem faced by those with incomes below the poverty level is not inadequate income for time worked, but the lack of a year-round job. Nearly half of the families below the poverty level did not have any family member employed. In effect, raising the minimum wage will do nothing to lift these people out of poverty, but it will further hinder their chances of finding employment and increase hardship since higher labor costs brought on by a higher minimum wage will raise inflation and lower overall economic activity.

Economic Effects of Raising the Minimum Wage

Ever since the Fair Labor Standards Act (FLSA) of 1938 instituted a federal minimum wage, numerous studies have shown that, contrary to its stated purpose of raising wages "without substantially curtailing employment," increases in the minimum wage do, in fact, reduce employment below the level that would prevail in the absence of such increases. While the stated aim of the legislation--raising the level of income of those employed at the minimum wage--may be attained, this is accomplished at the expense of other minimum wage workers who, at the higher minimum, become unemployed.

Increases in the minimum wage affect the economy by simultaneously reducing employment and raising inflation from the levels that would have prevailed in the absence of the increase. While the initial impact is felt by employers, particularly those in low-wage industries, whose wage bills rise with the higher mimimum, the increase in labor costs is not confined to low-wage industries or workers. When the minimum is raised, employers find it necessary to raise the entire wage scale to maintain wage differentials between employees with different kinds of skills. Thus, an increase in the minimum wage generally leads to a ripple effect of compensatory wage increases throughout the economy. A 1977 survey of small business reactions to the then-pending minimum wage increase found that 82 percent would have to increase wages of above-minimum employees to maintain the previously existing spread in wages of employees with different kinds of skills. 6/

Usually, businesses will deal with the increase in labor costs resulting from the higher minimum by either (1) passing the burden on to consumers in the form of higher prices and/or curtailed services (e.g., no longer provide free delivery services, etc.); (2) absorbing the added costs by reducing profit margins; or (3) passing these costs along to the workers themselves by reducing the numbers of hours worked, reducing the number of employees, freezing new hiring, or requiring that workers earn their increased wages through added work effort. In 1977, prior to the last increase in the statutory minimum wage, a survey of small businesses discovered that the previous time the federal minimum wage was increased, operating costs rose between 1 and 10 percent for 65.4 percent of the small businesses surveyed. In order to deal with the higher costs, 62.7 percent of the respondents said that they had raised prices between 1 and 10 percent, and 45.8 percent said that they absorbed costs by cutting into profit margins. But, these businesses also held the line on wage costs by reducing the number of hours that each employee worked per week (53.3 percent reported doing this), reducing the number of employees (47.6 percent), and freezing the hiring of new employees (81.3 percent). 7/

Thus, the first impact of a higher minimum wage is lower levels of employment and higher inflation. But this is just the beginning. Increases in the minimum wage cause other economic distortions which reverberate through the economy, thus reducing overall economic efficiency. A typical reaction to higher labor costs is the substitution of highly skilled workers and labor-saving machinery for low skilled workers. During the 1977 survey, 47.9 percent of the respondents said that they anticipated investing in labor-saving machinery or equipment if the minimum was raised (as it later was). 8/ This increase in the capital/labor ratio increases productivity and mitigates the initial inflationary impact of the higher minimum. But this forced substitution of capital for labor also leads to more unemployment.

These induced shifts in employment, earnings and productivity affect national income and aggregate demand, prompting firms to adjust production. Despite the increase in the minimum wage, the lower level of employment results in lower earnings. In addition, the rise in inflation, albeit tempered by the rise in labor productivity, reduces consumer purchasing power. Higher costs raise inflationary expectations, translating into a higher risk premium on interest rates. Higher interest rates depress activity in interest-sensitive sectors such as housing, automobiles and consumer durables. As a result, consumer spending declines, and as production adjusts to the lower levels of demand, investment and ultimately, real GNP also decline. This decline in overall economic activity is likely to cause a secondary wave of job losses until the economy settles at a level of activity which is lower than the one which would have otherwise prevailed.

The impact of a higher minimum wage is also felt in the international arena. Higher labor costs will have a significant negative impact on the international competitiveness of U.S. exports. Since 1982, U.S. manufacturers have operated at a disadvantage with respect to their foreign counterparts because labor costs were higher in the U.S. than abroad. For instance, between 1982 and 1985, hourly compensation of Japanese production workers was only half of the U.S. level. But since 1985, the declining value of the dollar together with significant improvements in U.S. manufacturing productivity (thanks to moderate increases in labor costs), have improved the competitiveness of American manufacturing. As a result, Japanese compensation has risen to 79 percent of that in the U.S., and compensation of production workers in West Germany, which was 75 percent of the U.S. level in 1985, is now 120 percent when expressed in dollars. 9/ This improvement in the international competitiveness of American products, so important to increasing exports and reducing the yawning trade gap, will be eroded by the rise in labor costs and inflation.

Empirical Evidence

Estimates of the employment effects of a higher minimum wage emphasize the impact on the teenage population, which is disproportionately represented in minimum wage earners. Studies have found that a 10 percent increase in the minimum wage would reduce teenage employment between 0.5 and 3 percent, with most studies yielding results in the 1 to 2.5 percent range. In 1981, the Minimum Wage Study Commission found that a 10 percent increase in the minimum wage reduced teenage employment between 0.5 and 1.5 percent. 10/ Given a total employed teen population of 5.8 million, this latter estimate means that a 39 percent increase in the minimum wage, from the current $3.35 to $4.65 per hour as has been proposed, would result in a loss of between 113,100 and 339,300 teenage jobs.

Studies of the inflationary impact of a 10 percent increase in the minimum wage estimate that total prices would rise between 0.2 percent and 0.9 percent. The Minimum Wage Study Commission found that the sustained rise in the minimum wage from 1974 through the second quarter of 1979 caused an average increase in direct wages of 0.3 percent which after three quarters rose to 0.7 percent because of the ripple effect. Indirect effects on price inflation, productivity and unemployment boosted the total wage inflation effect to 0.8 percent. A 10 percent minimum wage hike increased consumer price inflation by 0.3 percent. 11/ The smaller increase in consumer prices is caused by the effect of rising productivity which mitigates the impact of higher labor costs, but this increase is not enough to entirely offset the inflationary effects of a higher minimum.

In order to arrive at an estimate of the dynamic effects of the increase in the minimum wage that was recently proposed by Senator Kennedy (D-MA) and Representative Hawkins (D-CA), we performed a policy simulation using the Washington University long-term macroeconometric model of the U.S. economy. The exercise involves a comparison of two alternatives: one in which the minimum wage is maintained at $3.35 per hour through 1995, and a second where the minimum wage is raised to $4.65 in three years and thereafter indexed to 50 percent of nationwide average hourly earnings. 12/

A comparison of the two alternative scenarios shows the expected harmful results (see table, p. 6). The higher minimum wage increases hourly compensation and unit labor costs, and lowers the number of hours worked. The increase in unit labor costs peaks at 3.3 percent in 1993, and by 1995, they are 3 percent higher than would otherwise have been the case. Higher costs reduce the demand for labor, reducing civilian employment by an average of 1.1 million jobs per year, or a cumulative decline of 8.5 million jobs between 1988 and 1995. The unemployment rate is not only higher than the base case scenario, but rather than

Economic Impact of Increasing the Federal Minimum Wage [1]

	1988	1989	1990	1991	1992	1993	1994	1995
Minimum Wage ($/hr.)								
Base	3.35	3.35	3.35	3.35	3.35	3.35	3.35	3.35
Alternative	3.85	4.25	4.65	5.72	6.07	6.41	6.76	7.14
Hours Worked (%) [2]	-0.09	-0.36	-0.73	-1.16	-1.62	-1.95	-2.05	-1.99
Hourly Compensation (%) [2]	0.57	0.95	1.30	2.22	2.52	2.62	2.53	2.44
Unit Labor Costs (%) [2]	0.00	1.25	2.44	2.33	2.25	3.26	3.13	3.00
Civilian Employment (mill.) [3]	-0.06	-0.25	-0.55	-0.91	-1.33	-1.69	-1.86	-1.89
Unemployment Rate (%)								
Base	6.93	6.53	6.44	6.33	6.34	6.37	6.19	6.08
Alternative	6.97	6.72	6.83	6.96	7.25	7.50	7.41	7.29
Difference [4]	0.04	0.19	0.39	0.63	0.91	1.13	1.22	1.21
Unemployment Benefits ($B) [6]	0.12	0.47	0.99	1.63	2.37	2.95	3.22	3.23
Consumer Price Index (%) [2]	0.24	0.50	0.67	1.06	1.26	1.28	1.25	1.19
Treasury Bill Rate (%) [4]	0.08	0.13	0.14	0.25	0.25	0.22	0.20	0.19
Equipment Investment								
Difference ($82B)[5]	-0.55	-2.43	-5.48	-9.15	-13.07	-15.96	-16.90	-16.21
Percent Difference (%) [2]	-0.16	-0.70	-1.57	-2.54	-3.52	-4.17	-4.26	-3.97
Output Per Hour (%) [2]	0.00	-0.11	-0.11	-0.21	-0.16	-0.05	0.05	0.10
Nominal Personal Income								
Difference ($B) [6]	9.51	16.09	19.51	34.66	35.06	33.04	33.24	35.01
Percent Difference (%) [2]	0.29	0.46	0.53	0.87	0.83	0.74	0.70	0.69
Real Personal Income								
Difference ($82B) [5]	1.68	-0.53	-3.50	-4.49	-12.13	-16.37	-17.27	-16.30
Percent Difference (%) [2]	0.06	-0.02	-0.12	-0.15	-0.40	-0.53	-0.55	-0.50
Real Consumption								
Difference ($82B) [5]	-1.31	-4.28	-10.31	-16.81	-24.50	-31.33	-35.96	-39.61
Percent Difference (%) [2]	-0.05	-0.17	-0.39	-0.61	-0.88	-1.10	-1.23	-1.32
Real GNP								
Difference ($82B) [5]	-4.23	-14.71	-28.01	-43.69	-60.02	-70.84	-72.92	-70.83
Percent Difference (%) [2]	-0.11	-0.37	-0.68	-1.04	-1.39	-1.60	-1.60	-1.51

[1] To arrive at an estimate of the dynamic effects of the increase in the minimum wage recently proposed by Sen. Kennedy and Rep. Hawkins, we performed two simulations of the Washington University model. The base case holds the federal minimum wage at $3.35 per hour through 1995. In the alternative simulation, the minimum wage is raised to $4.65 per hour in three stages as follows: to $3.85 in January 1988, to $4.25 in January 1989, and to $4.65 in January 1990; thereafter, it is raised annually to a level equal to 50% of average hourly earnings (see footnote 12).

[2] Percent difference from base case.
[3] Difference in millions of jobs.
[4] Percentage point difference.
[5] Difference in billions of 1982 dollars.
[6] Difference in billions of current dollars.

Source: U.S. Chamber of Commerce, Forecasting Section, using the Washington University long-term macroeconometric model of the U.S. economy.

declining during the eight-year period, it rises. By 1995, the civilian unemployment rate is 1.2 percentage points higher than would otherwise have been the case, and 0.3 percentage points higher than in 1988. The higher unemployment rate is reflected in federal outlays, particularly unemployment benefits which are $3.2 billion higher by 1995.

Consumer prices rise above the base case, and by 1993 the consumer price index is 1.3 percent higher. Higher inflation is reflected in higher interest rates, and by 1995 the interest rate on three-month Treasury bills is 19 basis points higher than under the baseline scenario.

The substitution effect on investment in equipment is overwhelmed by the lower levels of demand and economic activity. By 1995 the level of investment is significantly below what would have otherwise occurred. This, in turn, affects labor productivity (output per hour) which falls in five of the eight years. Ironically, while the higher levels of compensation raise nominal personal disposable income above what would occur in the absence of the rise in the minimum wage, the induced increase in inflation more than offsets this nominal increase, leaving real income lower. Thus, the proposed increase in the minimum wage will result in a cumulative decline in inflation-adjusted personal disposable income of $68.9 billion between 1988 and 1995, an average falloff of almost $9 billion per year. Consequently, consumer spending also suffers, and real GNP is $70.8 billion lower by 1995.

Conclusion

These findings should not surprise the reader as they corroborate more detailed findings in countless other studies. The evidence is incontrovertible. Nevertheless, the myth persists, and every few years legislators propose to enact yet another increase in the minimum wage. In the process they congratulate themselves for such a clear expression of their superior morality and compassion. Yet this exercise in easy ethics only leads to greater hardship for all Americans.

But if the overall impact is negative, why is it that periodic increases in the minimum wage are enacted? The answer lies in the fact that some groups do reap benefits from regulations whose overall impact on the economy is negative. In a study entitled "Union Wages and the Minimum Wage," published in June 1981 by the Minimum Wage Study Commission, Henry S. Farber found that "...while changes in the minimum wage may have a temporary and relatively minor effect on negotiated wage changes, the existence of a minimum wage which is set substantially above the market wage may fundamentally alter the distribution of alternative wages available to union workers. The result will be a higher union wage structure than would exist in the absence of a minimum wage, and, while the effects of such changes on union wage changes seem small, the discrete change implied by the existence of the minimum wage may have had a somewhat larger effect." 13/

This conclusion was corroborated in a 1982 study by Peter Linneman, which shows that "...union members gained substantially from the presence of a minimum wage law in 1974. The average gain [in expected earnings] for a union member exceeded $400, while nonunion members lost an average of $8.00 per person in earnings. Furthermore, while 85 percent of the members of labor unions were expected to gain from the imposition of the minimum, only 44 percent of the nonunion population was expected to experience higher earnings in the presence of a minimum." 14/

* * *

Footnotes

1/ Barry Bluestone and Bennett Harrison, The Great American Job Machine, a study prepared for the Joint Economic Committee, December 1986, page 17.

2, 3, 4, 5/ Warren T. Brookes, "Low-Pay Jobs: The Big Lie," The Wall Street Journal, March 25, 1987.

6, 7, 8/ U.S. Chamber of Commerce, Center for Small Business, "The Effects of the Federal Minimum Wage on Small Business: Report of a Survey," September, 1977.

9/ Kenneth H. Bacon, "The Outlook: Shrinking Wage Gap Helping U.S. Firms," The Wall Street Journal, March 23, 1987.

10/ "The Employment and Unemployment Effects of the Minimum Wage," Report of the Minimum Wage Study Commission, Volume 1, Chapter 2, page 38.

11/ "The Impact of the Minimum Wage on Inflation," Report of the Minimum Wage Study Commission, Volume 1, Chapter 3, page 62.

12/ Because the Washington University model does not contain the particular earnings indicator that would be used as a reference for indexing the minimum wage, the variable "private nonfarm hourly compensation" (LCMHB) which is expressed in dollars per hour, was used as a proxy. LCMHB was adjusted as follows: It was determined that during the period 1964-1986 average hourly earnings averaged 73.37 percent of LCMHB. In order to establish the minimum wage in the years following 1990, therefore, we took 73.37 percent of LCMHB as a proxy for average hourly earnings, and 50 percent of that as the minimum wage.

13/ Henry S. Farber, "Union Wages and the Minimum Wage," Report of the Minimum Wage Study Commission, Volume VI, June 1981, page 131.

14/ Peter Linneman, "The Economic Impacts of Minimum Wage Laws: A New Look at an Old Question," Journal of Political Economy, Volume 90, Number 3, June 1982, pages 463-464.

A3840-11.4F 7/87

U.S. Chamber of Commerce Economic Policy Division

Policy Working Papers

April 1987 Number 4

THE BIENNIAL BUDGET
A PROMISING REFORM OF THE CONGRESSIONAL BUDGET PROCESS

by
Ronald D. Utt
Deputy Chief Economist

At perhaps no other time in our history has the federal budget been such a source of contention within Congress, and between Congress and the President. Throughout much of this decade, or at least so it seems, battles over the budget, the many programs that comprise it and the deficit that remains have dominated the legislative agenda. Reasons for the debate are obvious. In one dimension, the deficit, which both the public and public officials have decided is the single most important measure of anything having to do with the federal budget, has risen to levels that were unimaginable seven years ago. Worse, this increase occurred over a period when all segments of government, both political parties and most ideologies were in agreement that the reduction of the deficit was among this nation's highest priorities.

Another reason for all the fuss is that the federal budget is the battleground where the struggle between differing views about the proper role and responsibility of government occur. With this administration committed to making far reaching changes in the scope of government, such battles are more intense than usual.

Confronted with this pressure, the federal budget process is collapsing under the strain. Lots of time and energy are spent on the process but there is precious little to show for it when the year is over. Deadlines are seldom met. Major decisions are made at the last moment, and then rushed through Congress with little time available for careful review. In the end, virtually all major spending programs get lumped into one piece of legislation--called a continuing resolution. With a continuing resolution, Congress and the President are confronted with a single yes or no vote on the entire federal government. A no vote can shut the government down while a yes vote means support for the entire package. There is nothing in between and no room for compromise.

Many in Congress now recognize that a process that invariably pushes the hundreds of individual spending decisions to the end and then forces them into a single vote is intolerable and that something must be done to change it. Among the many proposals that purport to address the issue, the proposal to establish a biennial budget seems to be the most promising.

Policy Working Papers are published by the Economic Policy Division of the U.S. Chamber of Commerce to inform the American public about relevant economic policy issues. These studies are intended as timely and thought-provoking contributions to the national debate about these issues which are of particular importance to the U.S. business community and the public at large. Permission is granted to quote from this report with appropriate attribution to the Economic Policy Division, Chamber of Commerce of the United States.

At present, federal budgeting, as guided by the Congressional Budget and Impoundment Control Act of 1974, is an annual exercise with key decisions generally confined to, and applicable for, a single fiscal year. However, several of the component parts of the process, specifically authorizations and appropriations, vary in duration and may either be permanent, multi-year or annual. Some explanations are in order.

The authorization is the substantive legislation that establishes or continues a federal agency or program and also grants authority to enact appropriations. The authorization may also limit the amount of budget authority to be provided, or leave it to "such sums as may be necessary." Authorizations may be permanent (Social Security), multi-year (transportation and agriculture) or annual (State Department). About 15 percent of the budget is accounted for by annual authorizations, and the trend over time has been for Congress to convert permanent authorizations to annual ones in order to increase its control over programs.

Authorizations, however, provide no money for the programs they create, continue or modify. The actual funding of the programs is provided by the appropriations bills. Because the appropriations process establishes spending limits on programs that are authorized, it can be a powerful tool of oversight and control. Many programs, however, particularly the non-means tested entitlements like Social Security and Medicare, have permanent appropriations, while others require annual action by Congress. Of the $1,142 billion in new budget authority requested by the President for FY 1988, $779.9 billion will be available through permanent appropriations. As a result, a substantial portion of federal spending escapes the annual review of the appropriations committees.

The dilemma that confronts Congress is that while a preponderance of permanent appropriations diminish oversight, changing them all to annual appropriations in order to increase control and oversight could so overload Congress that effective oversight may decline even further.

Although authorizations and appropriations can be permanent, multi-year or annual, the budget process, which ties all of these together in a single plan, is binding for one year only, and the whole budget process must be repeated year after year. It is this combination of annual budget requirements--authorizations, appropriations and budget resolutions--plus the growing complexity of the budget itself and the political divisions over each of the items in it, that has allowed the budget process to consume a full year. The process begins in early January when the President submits his spending proposal for the next fiscal year, and then drags on until late fall or early winter before it is wrapped up. Sometimes the wrapping up is only temporary, and the government often begins the new fiscal year without a budget for the entire year!

This is a chaotic, frustrating and time consuming process that the average member of Congress finds almost impossible to monitor or influence. As deadlines press in on the process, compromises are put together at the last moment, with few members understanding exactly what they are voting for or against. Under such circumstances, little of what happens with each of the spending bills would be considered as effective oversight. And seldom is there time to sit back and make a careful assessment of each of the programs and conduct the reforms and changes where needed. As a result, programs continue to operate in the same old way regardless of whether the program does what it is supposed to do or is cost effective.

In an effort to better relate the vast number of required budget decisions with the time needed to effectively consider them, several members of Congress have proposed the creation of a biennial budget, or a two-year budget cycle. Supporters of the proposal believe it offers an attractive compromise between effective oversight and the efficient use of limited time. Under most biennial budget proposals, the approach would be to increase and rationalize the time that could be allotted to budget decisions and reduce the number of decisions to a more manageable volume.

The basic biennial budget plan would put most or all authorizations and appropriations on a two-year schedule. While there are a number of ways that this could be done, at a minimum, all one-year authorizations and appropriations would be extended for two years, as would the budget resolutions and the accompanying reconciliation bills. Permanent authorizations and those that now extend for more than two years could remain as is or be shortened to two years to conform with the rest of the budget.

There are a variety of ways in which the Congressional budget process could be modified to conform to the two-year schedule. Under the plan (H.R. 22) proposed by Representatives Panetta (D-CA) and Regula (R-OH), the first year of the cycle would be limited to oversight and the development of authorization bills. The second year would be used to pass the authorization bills and the two-year budget resolution. Work would then begin on appropriations bills, which would be passed near the end of the second year and before the beginning of the two-year budget cycle. Alternatively, with the legislation (S. 416) proposed by Senators Roth (R-DE) and Domenici (R-NM), the first session of each Congress would be spent processing a two-year budget resolution, two-year appropriations bills and a reconciliation bill. The second session of each Congress would be devoted to processing multi-year authorization bills and conducting oversight activities. Senator Ford (D-KY) has proposed still another alternative (S. 286) in which the first session would be devoted to developing a first budget resolution and the authorization bills, while the second session would be used for the second budget resolution and the appropriations bills.

A recent analysis by the General Accounting Office (GAO) looked into the experience that several states have had with their biennial budget process. Currently, 21 states have biennial budgets, down from 44 in 1940. In studying the experience in several states, the GAO concluded that: (1) Biennial budgeting does not require the state government's full-time attention for budget review every year. More time is available for non-budget activities in both the legislative and executive branches; and (2) Biennial budgeting lends itself to a more planned and deliberate approach to developing the budget, including the budget preparation process, analysis of policy issues and review of major budget proposals. It also provides time for longer range planning, if the state chooses to do so.

But some disadvantages were cited as well. They include: (1) The increased difficulty in estimating accurately revenues and expenditures in the second year and budgeting for "uncontrollable" items, such as changes in expenditures for entitlement programs; and (2) The legislature's perceived loss of control over the executive and state agencies, because there are fewer opportunities to make budget, program and policy changes.

Once the two-year budget is completed, it could be altered only through subsequent legislation, such as extended versions of the supplemental appropriations bills. Several of the biennial budget plans propose to make the subsequent supplemental process more difficult than it is at present by requiring, for example, a super majority vote (60 percent, for example, instead of 51 percent) to exceed the budget once it is passed. Under these plans, after a budget is passed by Congress, it can be breached only in response to an emergency.

While the rationalization of the budget process is the chief reason many in Congress support such a plan, other proponents believe that an added benefit would be lower federal spending. There are several reasons to believe that this might occur. First, much government spending is driven by aggressive special interests which attempt to get as much as possible, as often as possible, for the constituent groups that they represent. Often, they are unopposed by countervailing forces other than whatever can be mustered from responsible legislators and agency executives who are willing to stand up to the pressure. By moving to a biennial budget, these groups get just one shot at the budget every other year, instead of the existing opportunities for annual assaults on the taxpayers. By diminishing the pro-spending pressure, future budgets may be more fiscally responsible.

In addition to this, the biennial budget could further work to moderate government spending by taking advantage of peoples' natural propensity to put off tough decisions until the future. Any observer of federal budgeting can cite numerous examples of programs that most officials and congressmen agree could be cut back or eliminated, but are reluctant to do so immediately. As a result, such cuts or terminations are typically put off into the future or the next year where, under current budgeting procedures, decisions are not binding. When the next year becomes the current year and the formal decision to cut or not cut has to be made, politicians invariably change their minds and the planned cuts are avoided. With biennial budgeting, decisions about the future, however painful, would become binding and would be more difficult to reverse.

Examples of this sort of behavior abound. David Stockman's first budget for President Reagan included numerous, yet unspecified, future cuts to keep spending in line with lowered revenues. However, that decision was not binding, and a gap emerged that persists to this day. More recently, Congress agreed with the President in 1985 that revenue sharing should be terminated, but put off the actual decision until the next year. Although the program was finally terminated, the delay of the decision gave the program's proponents another chance to keep it alive and necessitated a second, close vote on the issue. While this was a case in which spending restraint ultimately triumphed, most delayed decisions go the other way.

Congressional budget resolutions, which establish budget totals for the next three years with only the totals for the immediate year made binding, offer the best example of the dichotomy in spending restraint between present and future years. In 1982, when Congress passed a binding budget resolution for FY 1983 with nonbinding spending totals for FY 1984 and FY 1985, the resolution proposed a spending level of $821 billion for FY 1984. But a year later, when it was time to actually put together a binding resolution for FY 1984, Congress opted to spend $845 billion, an increase of $24 billion over initial plans. Had the initial resolution been binding for the second year, as it would have been in a system of biennial budgets, actual FY 1984 spending might have been considerably lower. The same process occurred the next year when nonbinding totals for FY 1985 were proposed as part of the FY 1984 budget. Total spending of $906 billion was proposed for FY 1985. But a year later, when it was time to make the real decisions about FY 1985, Congress ultimately passed a budget that called for spending of $946 billion, an increase of $40 billion over what was planned. An examination of all of the budget resolutions for this decade indicate the same trend: tough decisions for the future, but retreat in the present. The biennial budget would take advantage of this propensity and work to drive down spending below what otherwise might occur.

Obviously, there is no guarantee that the process would function like this in actual practice. Once decisions about the future become binding, there is always the possibility that margins of excess could be built into multi-year budgets. At the same time, special interests which favor higher spending could also learn to take a longer view and act accordingly. Nonetheless, the mere possibility of lower spending, combined with the needed improvements in the mechanics of the process, suggest that the biennial budget should receive serious consideration by the Congress and the President.

A3840-11.5 F

7/87

U.S. Chamber of Commerce
Economic Policy Division

Policy Working Papers

May 1987
Number 5

THE NONBANK BANK CONTROVERSY CONTINUES

by
Rajni Bonnie Ohri
Economist

One of the most controversial aspects of the financial deregulation process is the mounting trend towards the formation of nonbank banks. Basically, a nonbank bank is an institution that, in order to avoid federal regulation under the Bank Holding Company Act of 1956, offers either demand deposits or commercial loans but not both. Nonbank banks are the subject of Congressional debate, court litigation, actions by state legislatures, debates among bankers, and discussion by federal and state bank regulators. This special status of nonbank banks has been exploited by bank holding companies, which want to use them as a vehicle to cross state lines, and by other organizations, such as brokerage houses and retail chains, which want to open up their own banking subsidiaries. As a result, nonbank banks are the center of a controversy that divides the financial community and draws conflicting responses from the federal banking regulators.

The Nonbank Bank

Many of the services that banks traditionally offer are now provided by other financial and nonfinancial firms. Merrill Lynch has a Cash Management Account while Sears Roebuck has Financial Centers in their retail stores. Thus, nonbanking firms have pushed into the realm of traditional banking activities, but without coming under banking regulation, by taking advantage of an apparent loophole in the Bank Holding Company Act (BHCA). According to the BHCA, if a firm owns a bank, which is defined as "any institution. . . which (1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans," then the firm is a bank holding company and therefore subject to the regulations associated with the Act. Consequently, nonfinancial firms have sought to avoid becoming bank holding companies by establishing nonbank banks which fail to satisfy the legal definition of a bank.

By eluding bank holding company status, these nonfinancial firms keep clear of the requirement to divest themselves of all business activities not permitted to bank holding companies under the BHCA, such as manufacturing, retailing or insurance brokerage. In effect, nonfinancial firms can own nonbank banks, which are chartered by bank regulators, can be members of the Federal Reserve System, and can obtain federal deposit insurance (FDIC). Nonbank banks are also subject to capital and reserve minimums, examinations and other requirements much like those imposed on full-service banks. It is not the nonbank banks that are unregulated; it is their parent organizations that are able to enjoy more freedom than the owners of traditional banks.

Policy Working Papers are published by the Economic Policy Division of the U.S. Chamber of Commerce to inform the American public about relevant economic policy issues. These studies are intended as timely and thought-provoking contributions to the national debate about these issues which are of particular importance to the U.S. business community and the public at large. Permission is granted to quote from this report with appropriate attribution to the Economic Policy Division, Chamber of Commerce of the United States.

Bank holding companies have perceived advantages to exploiting this loophole as well. Over 50 bank holding companies have applied for charters to open nonbank banks in numerous states. Because a nonbank bank is not considered legally to be a bank subsidiary, bank holding companies can use them as a vehicle to sidestep the Douglas Amendment of the BHCA, which prohibits a bank holding company from acquiring a bank in another state unless that state legislature specifically permits the acquisition. That is, bank holding companies can set up nonbank bank subsidiaries in other states without obtaining the state's permission, and engage to a limited degree in interstate banking.

Thus, not only can anyone acquire a nonbank bank but one can do so anywhere, thereby breaching the law's geographical restrictions as well. Today, there are over 200 nonbank banks in operation, owned by diverse companies including American Express, John Hancock Mutual Life Insurance Company and Ford Motor Company. Most of the holding companies that have established nonbank banks have employed them to provide a limited service (also called limited-service banks or consumer banks). Gulf & Western, one of the first companies to acquire a limited-service bank, uses its nonbank bank to support its credit card and consumer lending operations. Merrill Lynch started a nonbank bank so that it could process its cash management account customers' check and credit card transactions in-house, and offer its own insured deposits to money-market fund customers. Dreyfus Corporation pushed into banking to apply its mass-marketing techniques to the solicitation of consumer deposits and to offer mortgage and auto loans. And, Sears Roebuck uses its consumer bank (Sears Savings Bank) as part of its consumer financial services package.

The Signs of Change

One of the driving forces behind the nonbank bank movement is reflected in recent Federal Reserve Board data which reveals that banks are losing many of their commercial loan customers. In the 1950s, banks supplied 85 percent of U.S. corporations' short and intermediate term credit, they now provide only 60 percent of such credit, and the downward trend seems to be continuing. Most dramatic has been the drop in commercial and industrial lending, which is estimated to have slipped from 43 percent in 1974 to 27 percent today. Banks are unable to make up those losses in the consumer markets as they are no longer the primary source of individuals' credit. In 1985, finance companies, credit unions, retailers and savings institutions held 56 percent of all consumer debt; banks held 44 percent, down from 48 percent in 1980.

Clearly, companies outside the banking industry are increasingly diversifying and branching out into financial services. Ford Motor Company and General Motors operate finance subsidiaries that are no longer interested in merely extending auto loans. Both firms' subsidiaries are now heavily involved in mortgage banking. General Electric Corporation has become a major business lender, and with its recent acquisition of Kidder Peabody & Company, is now becoming a major investment banker.

What accounts for these changes? First, the highly volatile period of the 1970s and the early 1980s caused many different kinds of institutions to develop and market innovative financial products designed to achieve a greater return on their savings and investment. During that period, double-digit inflation pushed interest rates on government securities far above the interest rates the banks and thrifts were then limited by law to pay their depositors. Soon after, the money market fund industry exploded, drawing billions of dollars away from bank deposits. NOW accounts offered by thrifts in certain states had the same effect. Although Congress subsequently removed the interest rate ceilings on bank deposits, both thrift institutions and money market funds (and the securities companies that have sponsored the funds), have continued to be strong competitors to banks in providing transaction services. These events created additional demand for nonbanking financial services from bank customers, thereby generating an opportunity for new suppliers of financial services to enter markets in which they had not been able to compete previously.

Deregulation of interest rates bought on by the Depository Institutions Deregulation and Monetary Control Act of 1980 opened up a new era in price competition by phasing out Regulation Q ceilings, and thus facilitated nonbank bank competition in lending activities. Banks now had to pay more for their funds and had to increase the interest rates charged on loans. This situation narrowed their competitive advantage over lenders who rely on uninsured debt and equity to fund their activities, but who also do not incur the costs of reserve requirements, deposit insurance premiums and regulatory compliance that banks must bear.

In the early 1980s, the banking industry was also reeling from the steepest recession of the post World War II period. If this were not enough, this was followed by an international debt crisis; a period of disinflation that undermined the value of tangible assets such as real estate and commodities; and an oil glut. Two of those, agriculture and energy, are causing particular concern in the banking industry because of their regional concentration. Banks claim that they are inhibited by branching restrictions from adequately diversifying their loan portfolios and are thus exposed to devastating losses.

Furthermore, the booming securities markets of the 1980s have encouraged an increasing number of firms to raise funds through the capital markets rather than borrow from banks. In 1979, new securities (excluding commercial paper) offered by corporations totaled $52 billion and represented just 18 percent of the $291 billion in commercial loans held by banks. But by 1985 the volume of corporate securities issued, $156 billion, had soared to 31 percent of all end-of-year bank commercial loans ($496 billion).

In addition, quantum advances in telecommunications and computer technology now permit the rapid and low-cost transfer of funds and information worldwide. These advances are playing a significant role in eliminating political boundaries as barriers to the flow of financial capital. And, state restrictions are even becoming increasingly ineffective as more and more consumers are able to use nationwide computer networks to shop for and obtain banking services. Consequently, depository institutions are shunning traditional methods of offering financial services. For example, Greenwood Trust Company, the consumer bank owned by Sears, solicits deposits nationwide, promising savers higher returns and lower costs because of the absence of a physical branch network. Financial services firms that hope to survive and prosper in this rapidly changing environment will need to exhibit more flexibility than was required in previous decades. Nonbank banks represent an attempt by many firms to attain such flexibility.

Should the Loophole be Closed?

In today's financial reform debate, there are several arguments being advanced as favoring the imposition of new controls over the activities of nonbank banks. First, nonbank bank opponents claim that the banking system is an important element in the transmission of monetary policy, and nonbank banks undermine that function. However, those in favor of the nonbank bank claim that the issue concerns ownership and affiliations of financial institutions, not essential elements of monetary policy. The Monetary Control Act of 1980 requires that nonbank banks issuing demand deposits must be subject to reserve requirements. Although their parent companies may differ, the monetary status of banks and nonbank banks is the same under the Monetary Control Act.

Another argument concerns the impact of nonbank banks on safety and soundness of the banking and financial system--an issue which arises because depository institutions are custodians of a significant portion of the nation's wealth and payments system. The public interest requires the government to establish a protective safety net and to monitor the system. Thus, the essential issue for nonbank banks affiliated with other enterprises is whether they increase the overall riskiness of the financial system. Some would argue that such institutions are less risky than commercial banks since nonbank banks operating in the consumer market may have relatively low risk highly liquid assets generating a constant cash flow. They are not subject to sharp fluctuations in market value and may be more liquid than the consumer portfolio.

Another often heard objection is that a nonbank bank might be forced to lend to its parent or another subsidiary at preferential interest rates and without the appropriate credit quality controls. Should such a loan go bad, it could endanger the bank. On a related matter, there is also the concern that if the nonfinancial parent becomes bankrupt, regulators' fears that its failure will undermine the stability of the banking subsidiary and force them to bail out the parent, its creditors and other subsidiaries. Given that depository institutions and their insurers are already facing difficulties, the contingent liabilities that might arise from expanded ownership of banks could create further problems.

Nonbank bank opponents also argue that the deposits these nonbanks collect are not likely to remain in the same community. But nonbank bank owners claim that they usually are willing to offer higher interest rates on deposits, a wider range of services, and possibly even lower interest rates on loans--enticements that will threaten the ability of locally based institutions to compete. Once the local banks are pushed out by these competitive pressures, it is argued, service to consumers will suffer because the owners of nonbank banks will divert their attention and resources toward the more lucrative markets. Nonbank bank proponents claim that these objections are often raised by the owners of depository institutions in areas where new bank entry has been limited and local markets are protected by restrictive branching laws. In effect, the presence of nonbank banks will erode the barriers to interstate banking and enhance competition.

Thus, at the heart of this debate is the issue which led to the prohibition of interstate banking in the first place--will the authorization of interstate banking lead to increased concentration and decreased competition in banking? Many trade associations, such as the Independent Bankers Association of America, believe that greater concentration of financial resources at the national level will result and are thus opposed to interstate banking and nonbank banks. However, others contend that it is important to recognize that increased national concentration does not necessarily imply reduced competition at the local market level. Indeed, the elimination of geographical barriers to entry should result in more competition, greater efficiency, and more diversified services in the market.

Nonbank bank opponents also complain of the additional powers that can be exercised by the parent companies and affiliated subsidiaries. They argue that banks should be distinguished from other financial and nonfinancial providers, and that the government, through the regulatory agencies, should assure their safety and soundness. Many of these opponents also fear that product deregulation would permit large bank holding companies and other financial conglomerates to accumulate too much economic and political power.

In addition, nonbank bank opponents claim that because banks possess advantages such as entry restrictions, deposit insurance and access to the Federal Reserve Board's discount window, they would have a competitive advantage over other suppliers of financial services unless reciprocal entry is allowed. Federal Reserve Board Chairman Paul Volcker has maintained that continuing to allow nonbank banks to operate would be indicative of a failure to "respect the uniqueness of banking."

Nonbank bank opponents also maintain that the lack of regulation of nonbank banks' parent companies could cause tie-in sales to result. Those who oppose insurance, securities and retailing firms' ability to purchase banks speculate that customers of those highly diversified firms will be coerced into buying goods and services at higher prices. That is, they envision a consumer loan being approved only if the customer agrees to buy his life insurance or draperies from the insurance or retailing subsidiary of the holding company.

Many deregulation advocates argue that such potential problems can be eliminated through laws and regulations restricting or prohibiting tie-in sales, intracorporate and affiliate lending, and federally sponsored financial aid to the parent firm and other subsidiaries of a holding company that includes a bank. Nonbank bank proponents argue that the problem with nonbank banks lies not in who can own a bank, but in the fact that traditional bank holding companies are prohibited from responding to the competitive challenges that result from a constantly changing environment. The competitive pressure on banks is heightened when nonbank financial firms can offer close substitutes to banking services, while banks are prevented from responding with their own innovative products.

Clash of the Regulators

Nonbank banks are a major point of contention between the bank regulatory agencies, especially between the Federal Reserve Board and the Comptroller of the Currency. After years of delays and warnings to Congress, the Comptroller decided in October 1984 that he had no power to stop nonbank banks and began chartering new ones. The Treasury clearly favors faster deregulation of the financial marketplace, while the Federal Reserve Board wants to move with greater caution to insure safety and soundness of the banking system. About 280 applications to open nonbank banks in 38 states are awaiting approval by the Comptroller. In addition to receiving chartering authority from the Comptroller, these institutions must also receive Federal Reserve authority to acquire nonbank banks. The Federal Reserve essentially opposes nonbank banks because it believes proliferation of the organizations will undermine the BHCA restrictions on interstate banking and the separation of banking and commerce.

In addition to regulators' conflicts, legal battles have also blocked approval of nonbank banks. Recently, the Supreme Court allowed a New York-based holding company, U.S. Trust Corporation, to establish a subsidiary to run a nonbank bank in Palm Beach, Florida. Earlier this year, a U.S. Court of Appeals in Atlanta ruled that it was legal for a bank holding company to expand its consumer deposit-taking operations across state lines by means of a limited-service bank.

Congressional Response

Concern over the nonbank bank issue has generated much of the financial reform interest in Congress, including several legislative proposals to address the issue by imposing restrictions on nonbank banks. Indeed, the closing of the loophole has become the top priority of both the House and Senate banking committees this year.

Many trade associations such as the American Bankers Association, the Independent Bankers Association, the National Council of State Legislators, the Conference of State Bank Supervisors, the National Association of Home Builders, the National Federation of Independent Business, and the U.S. League of Savings Institutions support the closing of the nonbank bank loophole. While members of Congress have promised to halt the proliferation of these loophole banks, interest in setting up interstate networks of nonbank banks appears to be growing rather than diminishing. Included among the supporters of nonbank banks are the American Financial Services Association, the Association of Bank Holding Companies, the Consumer Bankers Association, the National Council of Savings Institutions, the American Retail Federation and the Dealer Bank Association. In addition, the Reagan Administration has openly endorsed nonbank banks, claiming that increased competition would benefit consumers.

On March 27, the Senate approved a comprehensive banking bill (The Competitive Equality Banking Act of 1987), that would essentially recapitalize the ailing Federal Savings and Loan Insurance Corporation (FSLIC), prohibit the establishment of new nonbank banks, and place a moratorium on expanded powers for banks. The bill (S. 790) closes the nonbank bank loophole by redefining a bank as an institution insured by the Federal Deposit Insurance Corporation, regardless of whether it accepts demand deposits or makes commercial loans. All nonbank banks operating as of March 5, 1987 would be allowed to operate for one year (this applies to 166 nonbank banks), but these institutions could not commence any new activities. After the one year moratorium expires, a 7 percent annual limit would be placed on their rate of growth. The bill also places some limits on the ability of nonbank banks to cross-market products and services among affiliates. The moratorium provisions in the Senate bill recently prompted the House Energy and Commerce Committee Chairman Dingell (D-MI) to ask the House leadership to refer S. 790 to his committee for consideration.

House Banking Chairman St. Germain (D-RI) will not consider the broad banking legislation passed by the Senate, but instead will only introduce single purpose bills. Recently, the House Banking Committee approved H.R. 27, a bill that would raise $5 billion through the borrowings in the capital markets for the insolvent FSLIC over a two-year period. Separately, the House approved legislation that would limit the time that financial institutions may hold deposited checks before making the funds available.

Prospects for enactment of major financial legislation are clouded by a number of factors, namely, the increasing inability of both the financial industry and members of Congress to reach a consensus on policy questions underlying the debate on financial reform. In addition, the Federal Reserve Board's recent decision to allow three major bank holding companies (Bankers Trust New York Corporation, Citicorp and J.P. Morgan & Company) limited authority to underwrite certain securities through subsidiaries, further blurs the legal line separating commercial and investment banking. However, the bank holding companies' ability to exercise their new powers could be delayed by legislation being considered by Congress. But since Congress has been unable to resolve financial issues in the past few years, much of the impetus for financial reform has been provided by state legislatures, federal regulators and the courts, and the same is occurring in 1987.

A3840-11.6F 7/87

U.S. Chamber of Commerce Economic Policy Division

Policy Working Papers

June 1987 Number 6

PRIVATIZATION AND THE AMERICAN EXPERIENCE

by
Ronald D. Utt
Deputy Chief Economist

So entrenched is the notion of big government here and abroad that we easily forget an all-encompassing state is a relatively recent phenomenon largely confined to the postwar era. Recognizing that this bureaucratization of America has created more problems than it has solved, one of this Administration's overriding policy themes has been the reversal of this federal encroachment. But efforts to convert the theme into action have consistently failed, and the government's share of our national income has been higher during the Reagan years than during any other peacetime period. As efforts to resolve the problem through significant budget cuts and program terminations met with overwhelming political resistance, some advocates of limited government proposed the concept of "privatization" as an alternative way of shrinking the state.

Privatization is defined as the transfer of government services and state enterprises to private sector owners and suppliers, and can be viewed as a "win-win", "positive sum" alternative that offers both the promise of better public service at lower cost and a much smaller, less intrusive government. Despite this promise, as well as the documented benefits from the recent, extensive British experience, the Administration's privatization proposals of 1986 and 1987 were swiftly rejected by Congress and the concept has now nearly vanished altogether from the general public policy debate. Even the Administration now seems wary about getting too far out in front on the issue.

In seeking an explanation for this loss of momentum and interest, one can't help but think that privatization supporters lost this battle because they let the opponents quickly label it as a fad, and this, in turn, enabled them to trivialize the concept before there was any serious discussion of it. Characterized as some "new fangled idea" and supported by many conservatives to boot, the average scholar, journalist, public official or politician took the path of least resistance and swiftly distanced himself from the concept.

This is an odd fate to befall a valuable tool of national policy. As a brief survey of our history demonstrates, reliance on the private sector and private initiative was typically the norm, not the reluctant exception, and was responsible for achieving feats and accomplishments that now seem unimaginable in our present era of growing dependence on government solutions and spending. As the examples that follow illustrate, private initiative and outright "privatization" contributed not only to the discovery and settlement

Policy Working Papers are published by the Economic Policy Division of the U.S. Chamber of Commerce to inform the American public about relevant economic policy issues. These studies are intended as timely and thought-provoking contributions to the national debate about these issues which are of particular importance to the U.S. business community and the public at large. Permission is granted to quote from this report with appropriate attribution to the Economic Policy Division, Chamber of Commerce of the United States.

of the land that would ultimately become the United States, but also to the survival and development of our nation at critical points in its existence.

The examples begin at the beginning when, in 1492 this hemisphere was discovered (rediscovered?) by Europe. Columbus' first voyage was, in effect, a public/private partnership. Although Queen Isabella did provide her fair share, about one-third of the funds was provided by the shipowner Martin Alonso Pinzon, who also captained the "Pinta" on the voyage, presumably to keep tabs on his investment. Such arrangements were not uncommon and many of the subsequent voyages to the new world were funded in whole or in part by the private sector. Although we now describe these endeavors as voyages of discovery and exploration, they were primarily commercial ventures seeking new trade routes to the Orient or the riches of undeveloped lands.

The voyages of Henry Hudson are probably typical of the commercial interest which motivated many of the ventures. Hudson's first two voyages to Canada represented an attempt to find a Northwest Passage from Europe to the Orient. Such a passage promised a shorter trade route, lower transportation costs and less expensive products. His ventures were funded by the Muscovy Company that had been organized earlier by Sebastian Cabot and several London merchants to monopolize the trade between Russia and England. The Muscovy Company itself was something of a financial innovation in that it was the first joint stock company in which invested capital remained in use instead of being repaid after every voyage.

The best known early settlements were also commercial ventures supported by private investors. Jamestown, for example, was funded by the Virginia Company of London, not the Crown. And perhaps the most famous settlement of all, that of the Separatists (Pilgrims) who landed in Plymouth, Massachusetts several years later, was a joint venture between religious dissidents and a London joint stock company. Indeed, two-thirds of those aboard the Mayflower, including John Alden and Myles Standish, were hired and sent along by the sponsors to protect the company's interest.

Private solutions loomed large again a century and a half later during our War of Independence when a young nation led by a poorly-funded Continental Congress took on the might of the British Empire. In 1776, our Continental navy possessed 27 warships against 270 for the British, a relationship that worsened as the American fleet fell to 20 by the end of the war while the British increased to almost 500. As a consequence, the navy was only occasionally effective despite the impressive heroics of John Paul Jones and others. To fill the gap, the Continental Congress effectively privatized our war effort by issuing letters of marque to privateers, entitling them to go after British vessels. These privateers were armed, privately-owned ships authorized to cruise the seas and attack and capture enemy ships. Their compensation consisted of the prize money from whatever they could capture and resell. By the end of 1777, they had captured 560 British vessels. When hostilities finally ended, the privateers had seized an estimated 1,500 British vessels and captured more than 12,000 seamen. By 1781, British merchants were appealing to their government to end the war.

Two decades later, in our war with the Barbary Pirates, it was again a private endeavor that struck the most significant blow. During the waning years of the 18th century, these pirates, operating out of Tunisia, Libya, Algeria, and Morocco, prowled the Mediterranean, demanded tribute and seized hundreds of merchant ships belonging to the Western nations, including those of the United States. Our history books tell us that the young republic thundered back: "Millions for defense, not a penney for tribute!", but the reality was that when Thomas Jefferson took office in 1801, an amount equal to about twenty percent of the government's annual revenue had been paid in tribute to the North African Moslem states. Several government military efforts were mounted, but they were not especially successful. We all learned in school how the daring Lieutenant Stephen Decatur penetrated the harbor at Tripoli, but his objective was only to destroy the Philadelphia, an American warship that the pirates had captured and whose crew of 307 still remained in captivity. The problem was not finally resolved until a largely mercenary army, privately raised and funded by William Eaton of Connecticut captured the Libyan port of Derna with the help of three man-o-war brigs which bombarded the port.

Eaton had been our consul to Tunis but was recalled at the request of their government because of his aggressive pursuit of U.S. interests. He returned later under the ambiguous title of "Naval Agent to the Barbary States," for which he declined any compensation unless his venture proved successful. In this capacity, Eaton financed a pretender to the Tripolitan throne and raised an army to pursue the claim. Comprised of sixteen U.S. marines and sailors, forty Greeks, a squadron Arab cavalrymen, 107 camels and more than a hundred others of unspecied origin, this ragtag army, numbering about 400, was led by Eaton through more than 500 miles of North African desert. In capturing Derna, Eaton offered the first real threat to the pirates, and forced the Bashaw of Tripoli to sue for peace and negotiate the release of the American hostages. Although Eaton calculated that his total costs came to around $39,000, Congress squeezed him down to $12,636.60, not a bad price for an event that would ultimately be enshrined in the Marine Corps' anthem.

The War of 1812 offers similar instances of private solutions and successes to military problems. When hostilities commenced, our navy was weaker than it was at the outset of the War of Independence: Against the 600 ships of the Royal Navy, the U.S. Navy had a dozen ships fit for sea duty. Although our navy was small, it fought with great skill and tenacity. The mighty frigates, the Constitution and the United States, achieved impressive victories against their British counterparts in numerous encounters. Still, the weight of numbers became the deciding factor and by 1813, much of our fleet was bottled up in port. Undaunted by the challenge, Congress again issued letters of marque and the privateers roamed the sea to disrupt British shipping. The brig "Yankee" alone seized or destroyed $5 million worth of British shipping during the war, an amount that was more than double the U.S. Navy's budget in 1812.

America's reliance on privateers in its first two wars was not some unpleasant necessity forced upon an embattled nation, but rather a conscious policy based on the principles of limited government. A big standing navy meant big government, big spending and higher taxes. Privateers, in contrast, cost little, were very effective in the warfare typical of the time (John Paul Jones' "Bonne Homme Richard" was a converted merchant vessel), and could be called upon only when needed. In times of peace they carried cargo from port to port. In 1856, all the major European powers except Spain signed the Declaration of Paris which declared privateering illegal. The United States refused to sign because its small navy made privateering necessary in time of war. Moreover, the United States refused to give up its right to commission privateers unless the principle of the immunity of private property at sea was generally accepted.

Although the wartime exploits of privateers offer some of the most dramatic cases in which our country sought private sector solutions to pressing national problems, our peacetime experiences with privatization offer some equally colorful instances. The Pony Express, for example, was not an adjunct of the United States Post Office, but rather an entrepreneurial initiative in response to inadequate postal service across the continent. Prior to the Pony Express, letters mailed from the East to California had to go by way of ships rounding Cape Horn, a journey of several months under the best of circumstances. Created by the firm of Russell, Majors and Waddell, the Pony Express was able to deliver letters from St. Joseph, Missouri to Sacramento, California in ten days with young men riding fast horses between 157 relay stations stretching across the 1,800 mile route. The business lasted for less than two years before going under, the victim, not of a more efficient Post Office, but of another group of entrepreneurs who built a transcontinental telegraph system which further shortened the time it took to get a message from one coast to the other.

Many other such cases abound. Private money, issued by private banks, was used extensively in the 19th century to aid the commercial development of the cash and credit starved frontier. The extensive network of canals that penetrated the unsettled parts of the Eastern states and brought coal, timber and food to the growing coastal cities and returned with needed manufactured goods was the outcome of one of the first major instances of a thriving venture capital market. Our great universities and teaching hospitals were not created by some early versions of the Departments of Education or Health and Human Services, but were founded by private individuals acting on behalf of their communities.

That we have somehow managed to forget this heritage suggests how utterly pervasive the notion of government involvement has become in our political and economic system. Once viewed as the solution of last resort, government now is often seen as the only appropriate provider of even the most trivial of services. It would be one thing if this situation was due to mere neglect and disinterest, but as we are now discovering, the belief in the primacy of government also, unfortunately, reflects a determined effort to suppress private alternatives even when they exist and are demonstrably better. A few years ago, for example, the House Budget resolution called for the shifting of billions of dollars of money-saving, government contracts with private firms back to the bureaucracy. It was never enacted, but, undeterred, the opponents of private sector solutions have recently introduced several pieces of legislation that would forbid the use of government funds to study the privatization of several existing government programs.

Considering the role that private initiative and private solutions to public problems have played in our history, this would indeed be a sad end to a valuable concept that has contributed so much to the American experience.

A3840-11.7F 7/87

U.S. Chamber of Commerce Economic Policy Division

Policy Working Papers

June 1987 Number 7

AMTRAK AND THE PRIVATIZATION OPTION

by
Rajni Bonnie Ohri
Economist

Because of the Gramm-Rudman Hollings Emergency Deficit Control Act, both the Congress and the President have been confronted with exceptionally difficult decisions regarding the course of federal spending. Despite the ongoing commitment to deficit reduction, projected federal deficits will be in excess of $150 billion for the foreseeable future and intense efforts will be required just to keep next year's budget deficit below the previous one. The Gramm-Rudman-Hollings Act (GRH) not only raises the stakes, but also provides enhanced powers to achieve the objective. In 1988 alone, it is estimated that over $50 billion in spending reductions will be necessary to meet the stipulated target of $108 billion. By fiscal year 1991, GRH requires that the federal budget be in balance. Meeting these objectives will require an unprecedented assault on federal spending and innovative solutions. That is why the privatization option--shifting the provision of many government programs and services to the private sector--may be the only solution to shrinking the budget deficit without jeopardizing economic growth.

The Budget Dilemma

Even with the enhanced powers provided by GRH, recent history demonstrates that the attainment of substantial deficit reduction targets through spending cuts have been a daunting endeavor. Last year was supposed to be the year that everyone got serious about the budget, but in the end it was business as usual. Although Congress has agreed to the Administration's goal of $36 billion in spending cuts, it should come as no surprise that this year's deficit is expected to reach an estimated $180 billion, instead of the $108 billion target set in the budget resolution and required by GRH.

Despite this bleak outlook, there is a politically attractive solution to the dilemma that offers substantial long-run potential for large savings: A massive and comprehensive program of privatization of every government activity that could be performed by a private sector entity. Although privatization itself is not likely to generate great savings during the next fiscal year, it could yield generous savings as the decade draws to a close. While such potential savings are of major importance in times like these when the deficit hovers near $180 billion per year, the main public policy attraction of a privatization program is that it is more politically saleable than the usual menu of program freezes and exterminations, and service and benefit reductions. Privatization does not eliminate programs nor does it necessarily reduce services. Indeed, it may even lead to more and better service. Privatization

Policy Working Papers are published by the Economic Policy Division of the U.S. Chamber of Commerce to inform the American public about relevant economic policy issues. These studies are intended as timely and thought-provoking contributions to the national debate about these issues which are of particular importance to the U.S. business community and the public at large. Permission is granted to quote from this report with appropriate attribution to the Economic Policy Division, Chamber of Commerce of the United States.

merely changes the provider by placing a greater share of management and production responsibilities within the more efficient private sector.

The Reagan Administration's fiscal year 1988 budget contains eight privatization initiatives designed to cut a total of $9.5 billion from the budget deficit. It intends to accomplish this by transferring government functions, wholly or in part, to the private sector. Several programs, such as the sale of Amtrak which will be examined in detail later, were introduced in last year's budget but Congress failed to act on them.

The Privatization Solution

The essential idea behind privatization is to identify those government services that could be more efficiently provided by the private sector. The general rationale of this strategy is to utilize the superior efficiency of the private sector and the competitive pressures of the marketplace to produce such services at the least cost possible. Numerous studies show that private firms often produce at prices which are substantially less than the average cost of similar services produced by the public sector.

Privatization covers several distinct ways in which the provision of government services can be shifted to the private sector. The three principal privatization mechanisms are load shedding, contracting out and vouchers. Load shedding refers to the process whereby the government transfers complete financial and production responsibilities to the private sector. While load shedding represents a valuable tool for privatizing some types of government activities, it is of limited usefulness in the case of certain essential public services and income redistribution programs. National defense, certain aspects of public health and basic law enforcement are examples of functions that would be difficult to shift to the private sector.

The other two methods of privatization, contracting out and vouchers, are partial privatization strategies and can be employed to improve the delivery of public goods and operation of income transfer programs. Contracting out allows the government to establish the objectives for programs and finance their cost, but places the responsibility for actual provision of the service in the private sector. Cost savings at all levels of government have been achieved through contracting out in areas ranging from garbage collection at the local level to medical care for the aged at the federal level. With vouchers, the government continues to fund the program and sets its objectives by providing a cash grant that is tied to a specific type of purchase. Food stamps and student loans are examples of existing voucher programs. A voucher is usually provided to classes of citizens believed by the government to earn insufficient income.

Amtrak: An Excellent Privatization Opportunity

Amtrak offers perhaps the most dramatic example of a privatization opportunity. The Reagan Administration, as part of its deficit reduction package, proposed the elimination of Amtrak subsidies and the termination of all Amtrak assets, the majority of which are in the Northeast Corridor, to one or more private sector companies, rail passenger organizations or other entities. This move to cut federal largesse has brought forth howls of protest from a small but vociferous clique of rail passengers, Amtrak management and employees, and selected members of Congress.

For over 100 years, inter-city rail passenger service in the U.S. was provided by private carriers. But in 1969, burdensome regulations, declining ridership and mismanagement in the passenger rail industry forced it to the point of economic collapse. The catastrophic losses suffered by the industry threatened the viability of passenger rail service, thus prompting Congress in 1970 to established the National Railroad Passenger Corporation (Amtrak) as a quasi-Government, for-profit corporation, responsible for organizing and managing a national system of rail passenger service. Since 1971, Amtrak has received $12 billion in federal subsidies for its intercity passenger services, and is expected to require another $7 billion over the next decade. When establishing Amtrak, Congress thought that a one time subsidy was all that was needed and that Amtrak would be self-sufficient thereafter. On the contrary, subsidies have continued and they now exceed $600 million a year, covering all capital spending and nearly one-half of operating costs. During its short history under federal ownership, Amtrak has grown increasingly reliant on federal operating subsidies. Between 1971 and 1981, annual taxpayer contributions to Amtrak grew from $140 million to over $1.2 billion. And as Table 1 shows, operating grants totaled about $8.5 billion. Not included in the table is another $1.1 billion in federal loan guarantees.

Table 1

Budget Authority for Amtrak
($ Millions)

Year	Grants	Northeast Corridor Purchases	Northeast Corridor Improvements	Total
1971	$40	--	--	$40
1972	80	--	--	80
1973	90	--	--	90
1974	149.1	--	--	149.1
1975	276.5	--	--	276.5
1976+Q*	602.1	--	$50	652.1
1977	575.7	$25	200	800.7
1978	666	25	400	1091
1979	730	24	490	1244
1980	851.4	12	381	1244.4
1981	906.3	--	350	1256.3
1982	735	--	168	903
1983	780	--	115	895
1984	735	--	100	835
1985	684	--	27.6	711.6
1986	587.5	--	12.5	600
1987	602	--	--	602

* "Q" was the transition quarter when the federal fiscal year was changed in 1976.

Source: Congressional Research Service, Amtrak: Background and Issues in the 99th Congress, September 1985, and Office of Management and Budget, Budget of the United States Government, FY 1987.

But persistent pressure from Amtrak's management and railroad passenger organizations, who continue to claim that Amtrak is making substantial progress, have convinced Congress to maintain subsidies to Amtrak, thereby failing to end the taxpayer's burden. Relying on scare tactics, Amtrak supporters pretend that there are only two solutions open to Congress: continue full federal subsidies or eliminate the service. Yet there is a third solution: privatization of whole or part of the system. This would be a sound alternative politically by giving key constituencies an ownership stake in the railroad and eliminating subsidies through improving efficiency rather than closing the system down. As long as federal subsidies continue, there will be little incentive to recover costs. Replacing subsidization with privatization will allow consumers rather than politicians to decide the fate of intercity rail passenger transportation.

Poor Track Record

Amtrak's performance under government ownership shows that the railroad has been a consistent money loser. In fiscal year 1972, its first year of operation, Amtrak reported a deficit of $153 million. By 1983, Amtrak's deficit had mushroomed to $805 million, with the prognosis for annual losses in the $700 to $900 million range for the forseeable future. Interestingly, the official losses reported by Amtrak are only the tip of the iceberg of public subsidies. During fiscal years 1979 through 1983, losses have amounted to over $3.8 billion. However, these do not include the interest-free, 99-year renewable loans it has received from the federal government. When total government assistance to Amtrak over those years is added up, the sum reaches a staggering $6.3 billion.

Other typical measures of Amtrak's progress such as number of passengers, passenger miles of travel and the market share have declined rather than advanced over the past few years. True, in the first decade of this century, railroads were carrying 95 percent of all intercity travelers. But competing modes of passenger transportation soon reached into the railroads' market share of traffic. By 1970, airlines dominated inter-city passenger travel, carrying 73 percent of the traffic, buses served 16 percent and railroads accounted for only 7.2 percent. These shifts in passenger volume, coupled with a rapidly rising rate of private automobile travel, left the railroads with very little passenger patronage. But politicians seem destined to continue subsidizing a form of transportation which now carries less than one-third of one percent of intercity traffic. In 1984, Amtrak boarded 11 million passengers at its 25 busiest stations. In contrast, airlines carried 202 million passengers at the nations's 25 busiest airports. And, since 1981 rail passenger miles have increased by only one percent annually, with short distance performance falling rapidly. In addition, Amtrak cannot be considered a federal program that benefits low-income consumers. Over 55 percent of Amtrak's passengers have an annual income of at least $30,000, while only 28 percent of the general population have incomes that high. As a result, the effect of continued Amtrak subsidies is to redistribute income upward.

Clearly, the increase in subsidies to Amtrak have only created both inefficiency and inequities. The average federal handout per passenger on all Amtrak routes is between $25 and $33, up from $3 per rider in 1973. Indeed, no other form of intercity transportation receives close to the taxpayer assistance extended to Amtrak. The 1982 CBO (Congressional Budget Office) study found that per passenger mile, Amtrak subsidies were over 100 times larger than subsidies to air, bus or auto passengers. Many analysts have asserted that it would be cheaper for the government to provide free airline tickets for all those who travel on Amtrak. Numerous studies have shown that it is those modes of transportation which are least subsidized that have done the best job of lowering costs. Between 1975 and 1983, the real cost per passenger mile declined by 19 percent for both commercial aviation and auto travel. The two most heavily government subsidized modes of travel, Amtrak and public transit, experienced increases of 19 and 13 percent respectively. This is powerful evidence for the advantages of a free and competitive market versus bureaucratically managed public monopolies.

The Key to Success

Although there is no evidence that the preservation of Amtrak is justifiable, it is still illuminating to consider the railroad's fate if the privatization option is chosen. The key to successful privatization is to convince Congress that by transferring the railroad or portions of it to private ownership, its long-term sustainability will be assured.

At no cost to the government, Congress can ensure that elimination of Amtrak's subsidy is accompanied by a transfer of ownership to those groups that are most concerned with its survival: current management, employees, passengers and rail groups. One strategy that has been considered is converting the government's preferred stock in Amtrak to common stock and offering it to these interested groups. They will then have an incentive to discover ways to make the railroad financially viable.

Another option deals with contracting out specific services of Amtrak. Because its work rules are archaic, its wage levels so high, and its labor protection provisions so unique and expensive, the railroad industry performs all services at higher costs than any competitor. For example, Amtrak suffers significant losses on its food service, running $9 million in the red annually on the Northeast Corridor and $33 million on long distance trains. Contracting out Amtrak's food service would both improve its food quality and reduce losses. At the very least, the contractor would not be bound by stifling work rules of labor agreements that drive up the cost of onboard train services. According to the Federal Railroad Administration, contracting out the food service could save a minimum of $15 million a year.

The most feasible Amtrak privatization strategy would be the consideration of the Northeast Corridor, clearly the route most amenable to private ownership and the political heart of the coalition to retain federal subsidies for the entire system. In the past six years, the Northeast Corridor trains have reported losses of about $20 per passenger, amounting to over $250 million per year. Amtrak's sustained losses have been caused by a number of factors such as high overhead, excessive labor costs, low productivity and mismanagement that could be avoided under private ownership.

For example, a large part of the railroad's current problems can be attributed to unsound political decisions. As long as Amtrak receives federal subsidies, politicians will seek to bend its business decisions to their own ends. Politics also interferes with Amtrak's ability to engage in long range business planning. As a federal corporation, Amtrak must appeal to Congress for funding, thereby leaving many operating decisions such as its capital investments, to be based on short term political considerations, not long term financial viability. Congress also requires Amtrak's Northeast Corridor to subsidize city commuter trains in the region. According to the Federal Railroad Administration, if private operators owned the Corridor, they could earn $80 million annually by charging the commuter trains for use of the track.

In addition, the railroad's labor productivity is among the lowest of all intercity transportation. The 1982 CBO study concluded that in 1981 Amtrak's labor costs per passenger mile was two to three times higher than those in the airline and bus industries. This differential is mainly attributed to the restrictive features of railroad labor agreements as well as higher wage rates. The "labor protection" obligation, common in the railroad industry, effectively prevents Amtrak from saving money by dropping its least profitable routes. As long as Amtrak is government-owned, employees have no incentive to improve efficiency as any savings would come out of their own pockets. If private firms could reduce the Northeast Corridor's labor costs by 30 percent, a feasible target, operating costs could drop by as much as $100 million.

Besides cutting costs, some critics believe that Amtrak could increase revenues by marketing itself more effectively. Competition would force private firms to offer better and more efficient service in order to attract rail passengers. Federal Railroad Administration data reveals that fewer passenger miles were recorded on the Northeast Corridor in 1986 than in 1981, and 50,000 fewer passengers rode the Corridor trains. These statistics suggest that an innovative marketing strategy, along with a more responsive scheduling system, could increase Amtrak's revenues substantially while slashing operating costs for low utilization trains.

Taking into consideration these potential reforms, a privatization strategy for the Northeast Corridor appears to be a promising solution. Properly managed and in the right markets, passenger railroads can operate effectively and profitably without government subsidies. For example, last year the Alaska Railroad, a passenger rail line run by the state of Alaska, earned a $2 million profit. And, in early 1986 private investors entered the rail passenger market and began the operation of the Tex-Mex Express, which travels the 160 miles between Corpus Christi, Texas and the Mexican border, and earned a profit in the first year.

One Possible Strategy for the Northeast Corridor

One recently developed Amtrak privatization strategy is modeled after the 1982 British sale of the government-owned National Freight Corporation (NFC), Britain's largest trucking establishment. The company was sold for 53 million pounds ($80 million) through an employee buy-out arrangement, with current and retired NFC employees obtaining over 80 percent of the equity. Since privatization, the employee-owned NFC has seen the value of their stock increase more than twenty-fold.

Those advocating privatization claim that Amtrak's Northeast Corridor could be privatized in a similar manner. First, transfer 80 percent of the

Northeast Corridor, including its track, real estate, facilities and equipment, to Amtrak workers and management by issuing them stock in a newly formed private company. Employees would have the right to retain or sell their shares to other employees. By turning the assets of the Corridor ("assets" which yield the government nothing but losses) over to the private sector in return for terminating the subsidy, a net saving to the taxpayer results.

The Corridor's employees should be offered the option of either working for the new private company or joining Amtrak's other operations. Each worker choosing the new company would be given an annuity worth the employee's accumulated pension benefits, to be cashed in upon retirement. The federal government must also guarantee to honor existing severance pay agreements, which provide up to six year's pay, to any worker who became displaced because of the transition to private ownership.

The remaining 20 percent of shares in the new company would be given to Amtrak's Northeast Corridor riders who have accumulated "frequent passenger" status (determined on the basis of the number of an individual's passenger miles), a strategy similar to the airlines frequent flier program. The new private company would maintain a minimum of 80 percent of the existing passenger miles now traveled by Amtrak in the Northeast Corridor for a twenty-year period.

The potential saving that the government derives from such a change could be substantial. The CBO estimates that eliminating federal support for Amtrak would save $610 million in outlays in 1987 and $3.2 billion from 1987 through 1991. And if sold to the highest bidder, the disposal of Amtrak's assets will generate revenues estimated to be $1 billion in 1988. But the real potential attractiveness of privatization goes beyond the budgetary benefits. It includes the opportunity for more efficient service at much lower costs, and the creation of political constituencies who stand to directly benefit from the change in ownership. In effect, the plan involves the buying out of the workforce with assets that are of no value to the government and taxpayers, but can be of value to employee-owners. The new owners would realize that with reasonable management the Corridor could be turned into a profitable operation, where profits accrue directly to the employees since they own the capital stock of the railroad. Individual users of the system would risk some changes of service but most would gain from privatization--lower costs and more efficient service. And the taxpayer would ultimately gain. Annual subsidies of $250 million on the Northeast Corridor alone would be eliminated in return for potential gain in tax revenues.

Numerous alternative privatization strategies for Amtrak also exist. Another strategy consists of auctioning off Amtrak assets to private passenger rail companies. It may also be possible to model the sale of Amtrak after the recent privatization of Conrail. In the largest stock offering in Wall Street history, this first major privatization project of the Administration netted $1.65 billion. In addition, Amtrak could be merged with another railway or transportation company.

Conclusion

A move towards the privatization direction was recently taken by the Department of Transportation. On March 6, Secretary of Transportation Dole announced the formation of a Commission to develop a comprehensive approach for eliminating federal subsidies for Amtrak while preserving economically feasible rail passenger service. The Commission will study a wide range of creative approaches, including proposals for private investments, state subsidies and employee stock ownership plans, and report to the Secretary in six months.

For the privatization of Amtrak to be successful, all those with with a stake in the railroad must be convinced that it has a profitable future if placed in private hands. Although critics of privatization will often acknowledge the gains to the federal treasury from asset and enterprise sales, they dispute the existence of subsequent operating efficiencies that allow the private supplier to provide the same service at lower costs. Arguing that the government can do it more cheaply because it is nonprofit and free of state, local and federal taxes, these critics fail to consider the powerful discipline that the competitive marketplace imposes on private business and how this can be translated into lower costs and improved service.

A 3840 - 11.8 F

7/87

U.S. Chamber of Commerce
Economic Policy Division

Policy Working Papers

July 1987
Number 8

FEDERAL BUDGET PROCESS REFORM: SURVEY AND ANALYSIS

by
William Orzechowski
Director of Federal Budget Policy

Control over the growth of public spending has to rank as one of modern civilization's most stubborn problems. Politicians continually pledge their allegiance to fiscal responsibility. Yet, fiscal responsibility has to be the world's most frequently broken promise.

The evidence is overwhelming. For example, in Europe total public spending averaged 30 percent of GNP in 1960. Today, in spite of many attempts to control spending, Europe is saddled with a public sector that takes up 50 percent of GNP. Although in the United States we have been more fortunate, the trend is in the same direction. Total public spending was approximately 29 percent in 1960. Today, it averages 38 percent. Even under Ronald Reagan, an avowed fiscal conservative, the federal share of GNP has risen from 22 percent in 1980 to 24 percent in 1986.

The relentless growth of public spending has caused many to search for solutions. In the United States many politicians have turned to budget process reforms. They have discerned that it is often difficult to obtain agreement among themselves to reduce spending on particular government programs. The pressure of special interest groups is often too great to withstand. As a consequence, they have turned to budget control devices that, in effect, force them to slow down spending growth. Without this "outside" restraint it is felt that Congress simply does not have the will to stay on the "diet."

The Experience With Budget Process Reform

The experience with budget process reform has not been impressive. Thirteen years ago, the entire budget process was overhauled with the passage of the Congressional Budget and Impoundment Control Act of 1974.

The purpose of this Act was to impart a sense of planning to the Congressional budget process. At that time, the thirteen appropriations committees were chiefly responsible for producing Congress' budget. A general criticism of this system was that it lacked coordination. The appropriations committees were accused of being too parochial in scope, making decisions that did not adequately reflect the national economic interest.

Policy Working Papers are published by the Economic Policy Division of the U.S. Chamber of Commerce to inform the American public about relevant economic policy issues. These studies are intended as timely and thought-provoking contributions to the national debate about these issues which are of particular importance to the U.S. business community and the public at large. Permission is granted to quote from this report with appropriate attribution to the Economic Policy Division, Chamber of Commerce of the United States.

The new budget act was supposed to rectify these defects through the creation of budget committees in both houses of Congress and a Congressional budget resolution. The budget committees would develop a budget plan or budget resolution that would serve as a guide for the appropriations committees. The budget resolution would presumably promote the general view and curb the parochial interests of the appropriations committees.

In practice, it does not appear that the system has worked well. Since 1974, the first year of the current budget process, federal spending has more than tripled from $267 billion to nearly one trillion in 1986. In the past seven years, Congress' spending has surpassed its own budget resolutions by an average of $25 billion per year. Over the same time span Congress has missed its deficit goals, on average, by $48 billion per year.

Gramm-Rudman-Hollings

Frustration with the current budget process led to the passage of the Balanced Budget and Emergency Deficit Control Act of 1985 or Gramm-Rudman-Hollings (G-R-H). G-R-H is a sweeping attempt at budget process reform, with the objective of forcing Congress and the President to reach a balanced budget by 1991.

The first part of G-R-H includes a schedule of deficit reduction targets. The targets are set each year to reach a balanced budget in 1991, beginning with a deficit target of $144 billion in 1987. The second part of G-R-H is the automatic sequester.

The purpose of the sequester is to enable the President to make automatic across-the-board budget reductions if Congress cannot meet its deficit target. In this way it was hoped that the problems of the budget process could be skirted. In effect, if Congress failed to pass a fiscally responsible budget resolution or the resolution itself failed to control the appropriations committees, then the sequester would be activated by law.

Gramm-Rudman-Hollings received a serious setback in July 1986 when the Supreme Court declared that the automatic sequester was constitutionally invalid. This means that the sequester, if needed, must now be passed by joint resolution of both houses of Congress and the President. In 1986, our lawmakers were unable to ratify such a resolution.

So far the verdict is not completely in with regard to G-R-H. On the positive side, federal spending growth has been reduced significantly. Before G-R-H, federal spending grew at a 10.5 percent annual rate from 1980 to 1985. This growth rate has since been reduced to 4.5 percent in 1986 and is currently running at 3 percent. In addition, the deficit has now begun to fall from its $220 billion level in 1986 and is expected to be about $180 billion in 1987.

On the negative side, Congress and the President have not come close to meeting the G-R-H deficit targets, and the attainment of a balanced budget in 1991 is a remote possibility. For example, the projected 1987 deficit of $180 billion is $36 billion above the $144 billion G-R-H deficit target for that year. In 1988, the G-R-H deficit goal is $108 billion, but our lawmakers are having great difficulty in developing a budget resolution that even meets a $136 billion deficit goal. Indeed, the political momentum seems to be drifting toward a formal relaxation of the G-R-H targets.

Stumbling Blocks

In light of the setbacks with G-R-H and the current budget process, attention is focused once again on budget reform measures. However, the obstacles in the way of effective budget process reform are quite significant. In fact, many question if budget process reform can even make a difference.

One major problem is loopholes. The federal budget is comprised of thousands upon thousands of programs that are entwined in a maze of technicalities that permit special interests to maintain spending through one accounting procedure or another. This makes it difficult for Congress to police its own budget resolution.

There are many gimmicks or "procedures" that can be utilized to circumvent budget controls. These include shifting payments from the end of one year to the beginning of the next; underestimating program costs (when Medicare began in 1966 it was estimated to cost $4 billion by 1980; it actually cost $32 billion that year); bundling many appropriations bills in one large continuing resolution which makes it difficult for the President to veto a specific appropriations bill.

A second problem is accountability. If budget controls are violated, and it is easy to demonstrate that this occurs with alarming frequency, there are no significant penalties for violation.

Third, there is the genuine problem of a public that is ambiguous about its own fiscal preferences. The public may desire a balanced budget but it may not want to take the necessary steps to reduce particular spending programs.

In spite of these difficulties, some important budget reform opportunities are discussed in the sections that follow.

Recommendations for the Future

In order to tighten up the present budget process, a variety of reforms have been recommended. These reforms strive to eliminate loopholes in the present budget process. In some cases, they delegate stronger budgetary powers to the President. In other instances, they involve micro-specific procedural changes. Finally, some argue that meaningful reform implies an outright subordination of executive and congressional powers to constitutional limits.

o **The Constitutional Balanced Budget Amendment**--By far, the most radical budget reform proposal is the balanced budget constitutional amendment. Many, including the recent Nobel

Laureate in economics, James Buchanan, see this as one of the few meaningful solutions available.

Advocates maintain that Congress and the Administration confront substantial barriers in limiting spending. In essence, the power of special interests is often too great to withstand. This is in spite of the many recent attempts to patch up the budget process. As a consequence, an outside "force", such as a constitutional balanced budget amendment, is needed to help Congress and the Administration. Our elected officials will find it easier to face the special interests by saying that the Constitution requires a balanced budget. They can say "your plan to increase spending must now compete with other plans for our limited resources, we can no longer pass the cost onto the taxpayer."

The operation of a balanced budget amendment is relatively straightforward. The federal government would be required by the Constitution to balance the budget on an annual basis. This requirement can be suspended in times of war and, in most versions, by a three-fifths majority in both houses of Congress. Some versions make it difficult to use tax increases in meeting the goal by imposing a constitutional tax limitation or requiring a super majority for tax increases. Many versions contain some provision for suspension if the economy is in a serious recession.

Currently, the most popular version in the House is an amendment, House Joint Resolution 321 (H.J. Res. 321), offered by Representatives Stenholm (D-TX), Craig (R-ID), B. Smith (R-OR) and Carper (D-DE). A similar version in the Senate, Senate Joint Resolution 161 (S.J. Res. 161), is being offered by Senators DeConcini (D-AZ) and Hatch (R-UT). The amendment requires an annually balanced budget unless waived by three-fifths majority. Tax increases require a majority of the whole number of both houses. Other provisions require the President to submit a balanced budget and require the President and Congress to submit a unified federal revenue estimate.

Making this provision the law of the land will be a difficult process. Any amendment to the Constitution requires a two-thirds majority in both houses of Congress and the approval of three-quarters of the states. In the House, H.J. Res. 321 already has 234 co-sponsors, putting it 57 votes short of the required two-thirds. In the House, the problem has been the Judiciary Committee which is reluctant to release such legislation to the floor. A discharge petition requiring 219 signatures is needed to get the bill on the House floor. One problem has been that some of the co-sponsors have failed to sign the discharge petition.

The Senate narrowly rejected a balanced budget amendment last year, and another attempt will likely be made this year. In 1983 the Senate passed a constitutional balanced budget amendment.

An alternative route is to bypass Congress and go right to the states. It takes two-thirds of all the states to pass the necessary legislation. So far, 32 of the 34 states required have made the call for a constitutional convention on the balanced budget. If one more state signs, this should provide sufficient pressure to get Congress to pass such an amendment. Future activity may occur in some states this year, especially Michigan, where the senate already approved a constitutional call.

One problem has been that in states such as Nevada, Texas, Florida, and Pennsylvania, efforts are underway to repeal the call for a constitutional convention. These rescissions have been turned back but future attempts remain a possibility. Opponents of a constitutional convention argue that the convention would not be limited to budget issues. Consequently, they fear that the Constitution could be laid open and modified in many other ways. But, the chances of this occurring are remote since Congress would more than likely enact its own version before the convention call, and also will review whatever the convention does. Moreover, it takes 38 states to pass a constitutional amendment, making it more difficult for extraneous amendments to pass.

o **Line Item Veto**--From the time of George Washington to Richard Nixon, the president had the power to refuse to spend money for specific programs that Congress had appropriated. Congress had no formal procedure to overturn such action. However, the Budget and Impoundment Control Act of 1974 eliminated this presidential prerogative and replaced it with weaker substitutes. In order to give the President greater ability to reduce spending growth, a line item veto and enhanced rescission power have been recommended.

A line item veto would allow the president to veto specific portions of an appropriations bill. As of now the president can only veto an entire appropriations bill. The president is often reluctant to do this since such bills contain many items, some of which may be essential to his agenda. Moreover, Congress often bundles many appropriations bills in one large package called a continuing resolution. A veto of a continuing resolution can often lead to a government "shutdown" making it even more difficult to veto specific, inefficient projects.

A line item veto would rectify the inertia that now exists. The President could review programs on their own merits without being forced to "swallow" them as parts of a large package.

Congress, especially the appropriations committees, have been reluctant to grant the line item veto. They view the line item veto as a reduction in their discretionary powers. However, the line item veto merely restores the impoundment powers that were eliminated with the 1974 budget act. Moreover, governors in 43 states possess such powers.

It is expected that line item veto legislation will be attached to debt ceiling legislation in mid-July. Senators Evans (R-WA) and Humphrey (R-NH) intend to offer such an amendment. As now proposed, their bill, S. 402., is actually a limited form of a line item veto that could be used only in conjunction with a continuing resolution, or when two or more appropriations bills are tied together.

o **Enhanced Rescission Power**--Senator Quayle (R-IN) will offer his enhanced rescission bill, Senate Continuing Resolution 16 (S. Con. Res. 16), as an alternative to the line item veto. Under present rescission rules the President can propose to rescind funds for specific programs. However, in order for the rescission to take effect, both houses of Congress must ratify it. If Congress merely abstains, the rescission is voided and the spending continues. Less than one percent of all Presidential rescissions were acted upon by Congress during the last two years.

Enhanced rescission power would "turn the tables" by requiring Congress to vote against the rescission if they want to retain the spending program. As a consequence, Congress would have to go on record as favoring more spending than the President.

o **The Automatic Sequester**--The automatic sequester was intended to be the "backbone" of the historic Gramm-Rudman-Hollings (G-R-H) legislation. According to G-R-H, Congress and the Administration are responsible for setting a yearly budget that would reduce the deficit in a series of incrementally lower deficit targets until budgetary balance is restored in 1991. Consequently, in each year our lawmakers must reach a specified deficit target. If Congress failed to meet these targets in any year, the automatic sequester would be triggered and spending would be cut on an across-the-board basis until the target is reached.

Unfortunately, the automatic sequester was declared unconstitutional by the Supreme Court. In its place is a joint resolution of Congress and the President. It is no longer "automatic" because if either house of Congress or the President dissents, the sequester fails. Last year, the sequester was rejected by joint resolution.

In order to restore the automatic sequester, legislation has been prepared to make the Office of Management and Budget (OMB) the executor of the sequester. This would rectify the constitutional defect of the earlier version. Senator Gramm (R-TX) has introduced legislation along these lines (S. 75), and it is expected that the bill will also be attached to debt ceiling legislation.

S. 75 contains other amendments aimed at strengthening the G-R-H process. One problem with G-R-H is that many programs are exempt from the sequester. An important reform is widening the spending program base for a potential sequester. This would spread the sequester over more programs, thereby reducing the amount any single program must absorb.

S. 75 has substantial support in the Senate where a similar version was passed last year by an overwhelming majority. The problem has been in the House where there is mounting support for an alternative sequester that has to be triggered by the President. This would make the President take the "heat" for spending cuts and absolve Congress. There is also the possibility that some members of Congress will want to weaken or stretch out the G-R-H deficit targets as part of new sequester legislation.

o **Biennial Budget**--There is considerable interest in a biennial or a two-year budget. Many lawmakers are convinced that a biennial budget can whittle down many of the procedural problems associated with the current budget process.

With current procedures a great deal of Congress' time is spent on a one-year budget resolution. Deadlines are often missed and decisions are postponed to the end of the fiscal year resulting in a large continuing resolution. This has created a variety of problems. First, too much time is wasted on budgetary issues. Second, the confusion and complexity that occur at the end of the fiscal year make it easier to push through inefficient programs. Third, the power of the authorization committees becomes diluted because there is little time to consider the thousands of programs the government operates.

With a biennial budget, the first year would be spent putting together a two-year budget and appropriations bills. The other year would be spent on multi-year authorizations. One prime advantage is that less time would be allocated to budgetary issues since budget plans would extend for two years. With two years to plan a budget, authorizations (the law that enables spending) would rationally precede and guide the development of appropriations bills. As a consequence, a biennial budget would help avoid the year end budget "crunch" associated with current practice.

A biennial budget is hypothesized to lead to greater fiscal responsibility. One argument is that with a two-year cycle, there is less chance for special interests to push their case for more spending. Congress would only have to deal with this pressure every other year. A two-year budget also has the virtue of making out- or second-year budget reductions stick. As a consequence, Congress can deflect special interest pressure by deferring spending reduction plans in the second year. With a biennial budget these out-year spending reduction plans will have the force of law.

Opponents argue that it is difficult to develop a two-year budget in light of economic uncertainties. As a consequence, there will be greater need for supplemental appropriations. Others argue that if the biennial budget gives Congress more time, then it might be used to support more not less spending programs.

The biennial budget has considerable bipartisan support. In the House, Representatives Panetta (D-CA) and Regula (R-OH) have developed such a proposal. In the Senate, Senators Domenici (R-NM) and Roth (R-DE) are expected to introduce similar legislation which will be attached to the debt ceiling bill in mid-July.

- **Capital Budget**--Adoption of capital budgeting would bring federal practice in line with standard business accounting principles. Proponents argue that it makes no sense to treat all federal investment outlays as ordinary expenses. Just as capital outlays of business firms are not wholly charged against current revenues to determine a firm's profit or loss, federal investment spending would no longer have to be counted as adding to the federal deficit in the year when such spending actually occurs. Instead, the budgetary cost would be allocated over a period of years approximating the life of the investment.

  Critics suggest that a capital budget would arbitrarily lower the computed deficit which would mean less pressure for budget control. A capital budget would also make it easier to push through spending projects since the capital costs would be amortized. In the private sector, there is little room for abuse with this practice since the firm is personally liable for the cost of capital purchased. In the public sector, there is the real danger that the amortization concept will be seriously abused. This is because politicians are not personally liable for capital costs, and there is a genuine threat that they would attempt to pass the costs of poor investments onto the taxpayer. In this sense full cost accounting can be viewed as a barrier against such abuse.

  A complete capital budget implies an estimation of the future liabilities of entitlement programs. Serious problems exist with estimating these liabilities. A slight change in economic and demographic assumptions mean a greater change in the imputed entitlements deficit.

- **Budget Resolution by Joint Resolution**--The Reagan Administration has many times recommended that the President should be a co-signer of the budget resolution. Their argument is that the executive branch of government should have a more direct impact over the federal budget. They feel that the President is less susceptible to special interests since the President is elected by the entire population. By contrast, Congress is more likely to be affected by local and more narrowly focused constituencies.

Budget "Stingers"

There are a number of micro-specific budget reform changes that can have at least a modest effect in reducing the growth of federal spending. Most of these proposals attempt to patch up some of the more glaring loopholes in the present budget process.

- **Stronger Reconciliation**--A reconciliation bill contains specific instructions that determine how spending reductions mandated by the budget committees are to be carried out. However, extraneous legislation that may increase spending is often attached to a reconciliation bill. A prohibition of extraneous legislation has been recommended to deal with this problem.

- **Spending Caps and Ceilings**--The appropriations committees, especially in the House, can often maneuver around some of the spending limits set by the budget committees. In order to curtail such behavior, firmer limits or ceilings on appropriations bills have been recommended.

- **Defense-Nondefense Allocations**--A common practice by the appropriations committees has been to reduce allocations set by the budget committees for defense spending for the purpose of increasing nondefense spending. Proposals have been put forward to end this practice by setting enforceable caps for defense and nondefense spending.

- **Control of Continuing Resolutions**--The budget year often ends with a large continuing resolution that bundles many appropriations bills into one large package. This makes it difficult to weed out inefficient programs. In order to comb through a continuing resolution for inefficient spending, line item veto or enhanced rescission power could be granted to the President. Such powers would be limited to the continuing resolution. Other recommendations would make it difficult to add spending bills to the continuing resolution.

- **Credit Reform**--In order to control the growth of federal loans and loan guarantees, sweeping reform has been proposed. New loans would be estimated for their subsidy content, and the agency responsible would have to obtain appropriations equal to the subsidy. Old loans would be sold to the private sector at a discount that reflects the rate of subsidization. In this way the massive subsidies imbedded in such programs would come to light and program abuse would be discouraged.

Conclusion

It is no secret that the current budget process contains many defects. Deficit targets have been routinely missed. There seem to be a million and one ways to avoid budget controls. As a consequence, budget process reform has become an important legislative issue, once again.

Unfortunately, the problem runs deep and may require significant institutional change such as a constitutional balanced budget amendment. In the short run, however, there exist a number of promising budget process reforms. These include the automatic sequester, line item veto, biennial budget and a host of procedural recommendations. Most of these proposals are expected to receive national attention in conjunction with this year's debt ceiling bill.

A3840-11.9F
8/87

U.S. Chamber of Commerce   Economic Policy Division

Policy Working Papers

July 1987   Number 9

FINANCIAL LEGISLATION EMERGES

by
Rajni Bonnie Ohri
Economist

A House-Senate conference committee recently concluded intense negotiations over a comprehensive banking bill that includes an $8.5 billion recapitalization plan for the Federal Savings and Loan Insurance Corporation (FSLIC), limits on nonbank banks, and a moratorium on new powers for commercial banks. In addition, key provisions of the bill would also prevent FSLIC-insured institutions from leaving the insurance fund for one year, require the Federal Home Loan Bank Board to design a regulatory forbearance program for thrifts operating in economically depressed areas, provide faster check clearance by banks, give federal regulators broader authority to deal with failed and failing institutions, and extend the emergency acquisition authority under the 1982 Garn-St. Germain Act.

The Nonbank Bank Loophole

Title I of the bill would close the nonbank loophole by redefining a bank as any institution covered by the Federal Deposit Insurance Corporation (FDIC), or that makes commercial loans and offers transactions accounts. Nonbank banks are institutions that either take deposits or make commercial loans, but not both activities, and thus are not considered banks as defined by federal law. All nonbank banks established by March 5, 1987 would be allowed to continue operating, but with restrictions. This applies to nearly 168 nonbank banks. Those nonbanks would be subject to a 7 percent annual limit on asset growth, beginning one year after the date of the bill's enactment. Nonbank banks would also be restricted in their ability to cross-market products and services with their parent company unless they were being marketed jointly as of March 5, 1987. And, these nonbanks cannot establish any new locations nor may they commence any new activities.

In addition, nonbank banks would be barred from running daylight overdrafts, that is, overdrawing their accounts at their Federal Reserve Bank, a common industry practice. An exemption was granted for nonbank banks that are also primary dealers. Other restrictions included prohibiting nonbank banks from acquiring more than 5 percent of another bank or thrift, and

Policy Working Papers are published by the Economic Policy Division of the U.S. Chamber of Commerce to inform the American public about relevant economic policy issues. These studies are intended as timely and thought-provoking contributions to the national debate about these issues which are of particular importance to the U.S. business community and the public at large. Permission is granted to quote from this report with appropriate attribution to the Economic Policy Division, Chamber of Commerce of the United States.

allowing nonbank bank owners to convert the institution into a credit card bank only during the first 180 days following the bill's enactment.

This title of the bill also tackles the issue of nonthrift thrifts by imposing a qualified-thrift lender test on unitary savings and loan holding companies. Under the Savings and Loan Holding Company Act, unitary thrifts are permitted broad powers to engage in nonbanking activities. The qualified-thrift lender test would require such thrifts to devote at least 60 percent of their tangible assets to residential real estate if they wish to retain those powers. Purchasers of failed thrifts have up to ten years to comply with the qualified-thrift lender test.

Bank Powers Limitations

Title II of the bill imposes a strict moratorium from March 5, 1987 until March 1, 1988 on the authority of federal banking agencies to grant new securities, insurance and real estate powers for banks. The moratorium would apply to certain foreign banks and bank holding companies as well. The conference committee also agreed to one permanent curb on new bank powers. This restriction would extend to state-chartered banks that are not members of the Federal Reserve System those provisions of the Glass-Steagall Act that prohibit affiliations with firms "engaged principally" in underwriting on certain kinds of securities. Currently, states have the authority to grant a broad range of securities activities; this amendment was aimed in particular at New York regulators, where broad powers for state-chartered nonmember banks have been proposed.

The conferees strengthened the moratorium by prohibiting federal banking agencies from allowing "by action, inaction, or otherwise," any securities activities not legally authorized in writing prior to March 5, 1987. However, sales or transactions closed as of June 30, 1987 would be exempt from the limitation. This measure was directed primarily at the Office of the Comptroller, which frequently permits new activities simply by taking no action to prohibit them. In addition, banks were also prohibited from operating a "nondealer marketplace in options," a measure aimed directly at Security Pacific Corporation, which is awaiting permission from the Federal Reserve Board to provide brokerage and clearing services for options on Treasury obligations.

Rescuing the FSLIC

After more than a year of uncertainty, the House-Senate conferees agreed to an $8.5 billion (with no more than $3.75 billion to be borrowed in any one year) recapitalization plan for the troubled FSLIC. In approving this borrowing authority, rather than the $7.5 billion proposed by the Senate or the $5 billion passed by the House, the conferees were setting aside more than $800 million to replenish the secondary reserve used up by the Federal Home Loan Bank Board (FHLBB). The reserve was confiscated by the FHLBB after the FSLIC was declared insolvent. That action raised the prospect that thrifts would have to begin writing off the secondary reserve. Thrifts, however, will recover their contribution to it through a credit against the premiums they pay the FSLIC.

The bill also provides forbearance for thrifts with at least 0.5 percent regulatory capital if the institution is a victim of external economic conditions, not of mismanagement. The forbearance package would allow the thrifts to appeal certain examiner decisions affecting their asset values and capital requirements. The bill also requires the FHLBB to establish an appraisal review process to guard against overly conservative or optimistic evaluations, a new system for classifying assets consistent with the practices of commercial bank regulators, and new appraisal standards also consistent with commercial banking practices.

In addition, the bill would prohibit healthy thrifts from leaving the FSLIC for one year, after which they could apply for insurance from the FDIC and pay a penalty for leaving the fund. Because of the problems associated with the FSLIC, many thrifts have already applied for bank charters. The penalty, or exit fee, would be equal to twice the sum of special and regular assessments levied by their regulator. The bill also would direct thrift regulators to require use of generally accepted accounting principles and requires an annual audit of the Federal Asset Disposition Corporation, which was set up to warehouse and dispose of assets acquired in thrift foreclosures.

Deposit Availability

The bill's Title VI instructs the Federal Reserve Board to develop guidelines within three years that would require banks, thrifts and credit unions to make funds from "local checks" available to customers after one intervening business day. A local check is being defined as an item within the boundaries of a Fed check-processing district, not just the same city. For nonlocal checks, the Fed could permit holding the funds up to four intervening business days. Rural institutions are to be given additional leeway because their checks often take longer to clear than those of other banks.

The bill also establishes an interim schedule that will take effect one year after the bill becomes law. This would limit check holds to a maximum of two intervening business days on local checks and six days for other items. In addition, institutions would be subject to disclosure requirements. They would also be required to begin computing interest for checks deposited in interest-bearing accounts as soon as they receive "provisional credit."

There is also a provision in the bill requiring that deposit-taking institutions compute interest based on full account balances. Many institutions have paid interest based on investable balances--what is left over after reserve requirements and insurance premiums are paid--without notifying depositors.

Regulatory Provisions

The conferees' bill also contains provisions to give regulators authority to arrange interstate mergers of failing banks with assets of at least $500 million. In effect, this provision extends Title I and II of the Garn-St. Germain Depository Institutions Act which had expired last fall after several temporary extensions. The measure also permits regulators to establish "bridge banks" so that the FDIC can operate a failed bank until a buyer is found.

In addition, the bill exempts federal regulators from across-the-board budget cuts built into the Gramm-Rudman-Hollings budget-balancing law, a move that will push the agencies to add more examiners to their staff. The conferees also freed regulators from the federal requirements that they need not exceed their budgets.

Another provision in the bill requires the General Accounting Office to consider whether banks should be forced to cash government checks without charge, regardless of whether the person cashing the check is a bank customer. And, the GAO must conduct a study to determine whether the Fed should pay fees to banks when presenting checks to be cleared.

The bill also contains provisions permitting qualified farm banks to amortize losses from agricultural loans over seven years. A qualified agricultural bank is defined as one that has less than $100 million in assets and has 25 percent of its total loans in agricultural ventures.

Conclusion

Though approved by the conferees relatively swiftly, the bill still faces several obstacles. Because the FSLIC funding provisions in the bill go beyond what either the House or Senate banking committees had approved, the bill must now be cleared by the House Rules Committee prior to final House and Senate action on the measure. Previously, the Rules Committee was instrumental in killing a bill to close the nonbank bank loophole during the second half of the 99th Congress.

The following associations essentially support the conferees' bill: the Independent Bankers Association, the U.S. League of Savings Institutions, the National Council of Savings Institutions, the Securities Industry Association, and the National Federation of Independent Business. The American Bankers Association supported closing the nonbank bank loophole without weakening the growth limitations on grandfathered companies.

Included among the opponents of the bill are the Association of Bank Holding Companies, the American Financial Services Association, the Consumer Bankers Association, and the American Retail Federation.

The Administration seems poised to veto the bill, arguing that it does not raise enough funds for the ailing FSLIC, and that its nonbank bank provisions and new bank powers moratorium are anticompetitive. The Treasury Department also continues to favor faster deregulation of the financial marketplace and is pushing the President to veto the bill. However, the Federal Reserve Board's outgoing Chairman Paul Volcker wants to move with greater caution to insure safety and soundness of the banking system. Mr. Volcker continues to oppose nonbank banks because of the potential conflicts of interest between the institution and its owner and the threat that the institutions might pose to the interbank payments system.

Deep divisions within the financial services industry have made Congress' job all but impossible, but Chairman Proxmire expects Congress to vote on the legislation by this fall. Although three titles of the bill received the most attention--the nonbank bank curbs, the new powers moratorium, and the FSLIC recapitalization--the package is considered by many to be the most ambitious banking legislation to clear a conference committee since the Depository Institutions Deregulation and Monetary Control Act of 1980.

A3840-11.10 F

8/87

U.S. Chamber of Commerce

Economic Policy Division

Policy Working Papers

July 1987

Number 10

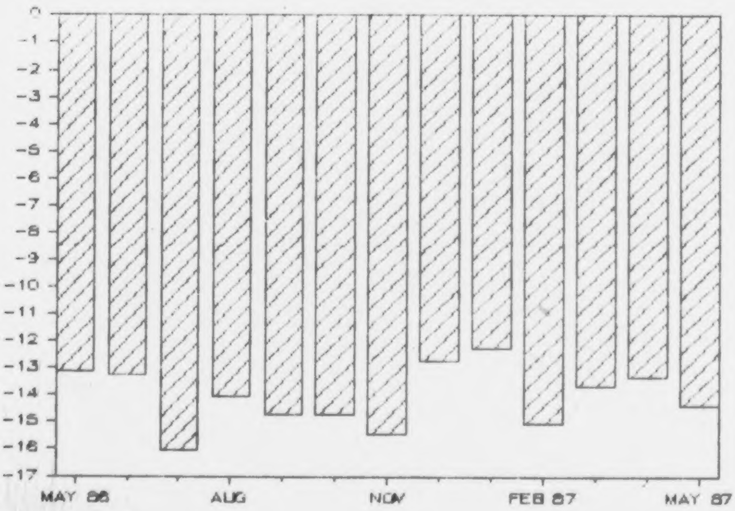
THE PROTECTIONISTS ARE LOOKING AT THE WRONG PICTURES

by
Graciela Testa-Ortiz
Director, Forecasting Section

> "It's all been said before, so remember
> every picture tells a story, don't it?"
>
> Rod Stewart

Following last week's release of the merchandise trade data for May, virtually every newspaper in the country carried the following picture:

U.S. MERCHANDISE TRADE BALANCE
(Billions of Dollars)



The widening of the merchandise trade deficit was offered as further proof that things just aren't working out the way they are supposed to. According to The Washington Post, the increase in the deficit ended "a brief improvement that had encouraged hopes the big deficits were receding."[1] Comments on Capitol Hill were of the same nature. The Journal of Commerce quoted a

Policy Working Papers are published by the Economic Policy Division of the U.S. Chamber of Commerce to inform the American public about relevant economic policy issues. These studies are intended as timely and thought-provoking contributions to the national debate about these issues which are of particular importance to the U.S. business community and the public at large. Permission is granted to quote from this report with appropriate attribution to the Economic Policy Division, Chamber of Commerce of the United States.

senator as saying that "the continuing trade deficit warrants swift passage of the [trade] legislation ... If we continue at the May rate we'll have a trade deficit for the year of $175 billion."[2] The Journal of Commerce concluded that "the May trade data may give members of Congress pushing for 'tough' new trade legislation additional negotiating leverage."[3]

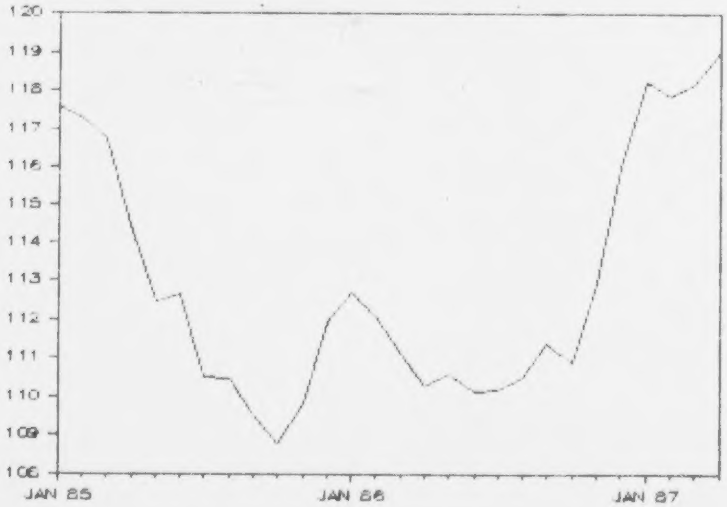
The trade gap and what, if anything, to do about it has been the subject of a significant amount of policy confusion. During 1980-1985, the trade deficit was blamed on the then appreciating dollar. The ongoing devaluation of the dollar since 1985 was deemed necessary to narrow the deficit. Yet the patience of our policymakers wore thin as the dollar continued to slide with no apparent progress in reducing the deficit. These policymakers now believe that the answer to this dilemma lies in a trade bill. If the trade deficit won't come down despite the decline in the value of the dollar, then they'll reduce it via legislation.

The purpose of this paper is not to argue the reasons for our trade deficit and its apparent intractability, nor the relative merits of alternative solutions. It is only to point out a fact that is being conveniently ignored, namely, that the trade picture has already improved markedly.

Instead of looking at the trade deficit -- the difference between exports and imports -- let's look at the components themselves. Clearly, if exports are growing at a healthy pace, one must conclude that things are improving. And if there is a simultaneous deceleration in the rate of growth of imports, then the battle is half over.

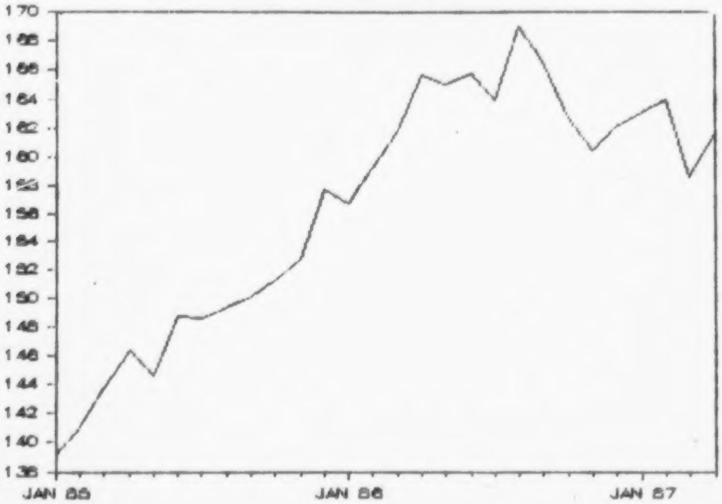
From this perspective we see that improvement began quite a long time ago and continues virtually uninterrupted. In volume or quantity terms, exports turned around in July 1986 and have since risen by 8 percent.

MERCHANDISE EXPORT VOLUME
(7 Month Moving Average)



And import volumes peaked in August 1986 and have since fallen by 4.4%.

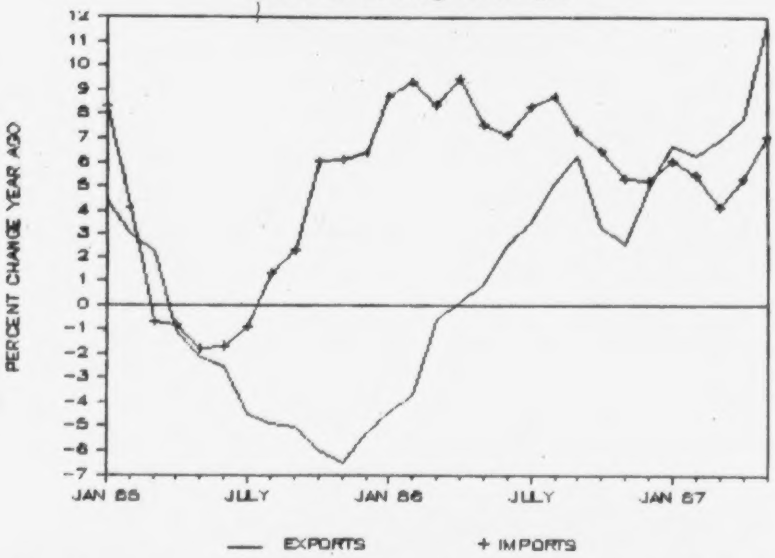
MERCHANDISE IMPORT VOLUME
(7 Month Moving Average)



As far as the National Income and Product Accounts are concerned, it is inflation-adjusted exports and imports of goods and services that matter. Real export growth began to increase in the third quarter of 1985, and has been an important contributor to total output, rising three times faster than real GNP (by 11.5 percent compared to a 3.7 percent increase in real GNP between the third quarter of 1985 and the first quarter of 1986). The growth rate of real imports of goods and services began to trend downward a year later, in the third quarter of 1986. As a result, by this measure -- real exports of goods and services minus real imports of goods and services -- the trade deficit began shrinking in the third quarter of 1986 and has since improved by nearly $30 billion.

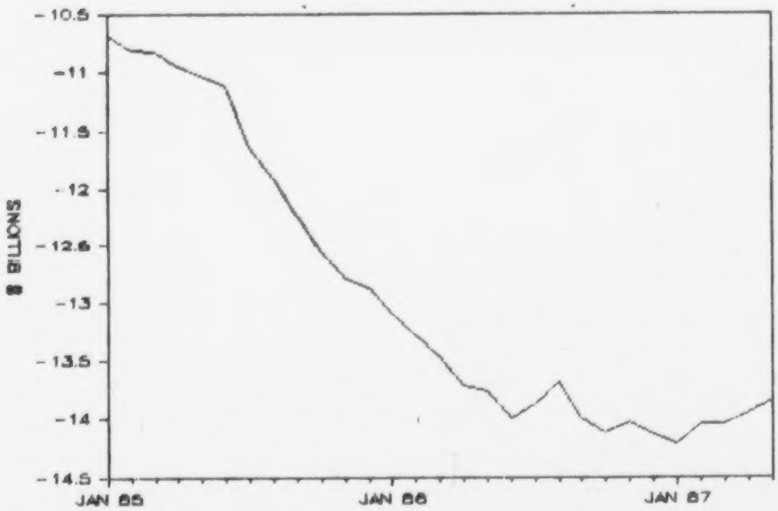
But the national preoccupation, I should say, obsession, is with nominal dollar value of exports and imports of merchandise, a data series that suffer from significant statistical problems, as evidenced by the magnitude of later revisions, and which are extremely volatile on a month-to-month basis because they are not adjusted for seasonal variations. In order to adjust for volatility and seasonality, the charts depict moving averages of the series. Yet, even with these flaws, the merchandise trade numbers, expressed in nominal dollars, show a major improvement. As the chart shows, exports of merchandise have been rising at ever faster rates since November 1985. The rate of growth of merchandise imports appears to have peaked in August 1986, moving in an erratic, but clearly downward, direction since then.

MERCHANDISE EXPORT AND IMPORT GROWTH
(7 Month Moving Average)



As a result, the chart of the smoothed merchandise trade deficit shows that it has "bottomed out," that is, it has been virtually stable since April 1986, hovering between $13.7 billion and $14.2 billion. Moreover, a careful examination of the past two months of data for this smoothed series shows a decided upturn.

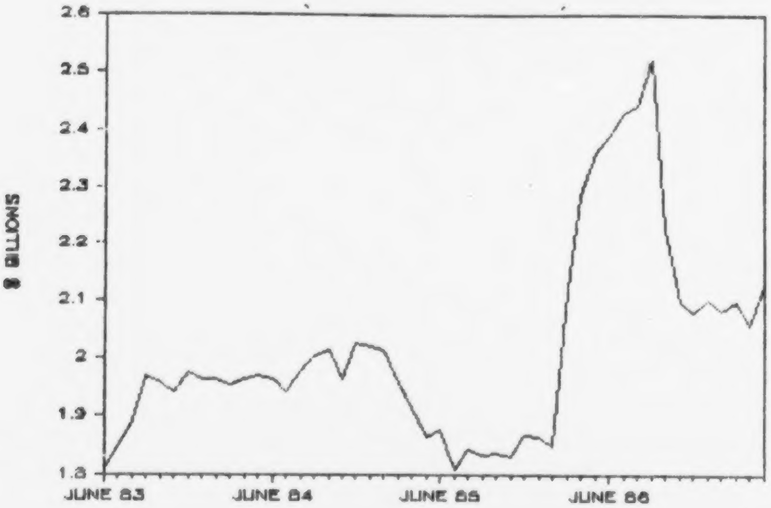
MERCHANDISE TRADE BALANCE
(12 Month Moving Average)



Not only is this true of total dollar value of merchandise exports and imports, it is also true of our bilateral trade. U.S. exports of merchandise to Japan troughed in March 1986 and rose by about 39 percent between March and October of last year. After October they fell precipitously as the Japanese economy teetered on the brink of recession. Yet, in spite of the decline, U.S.

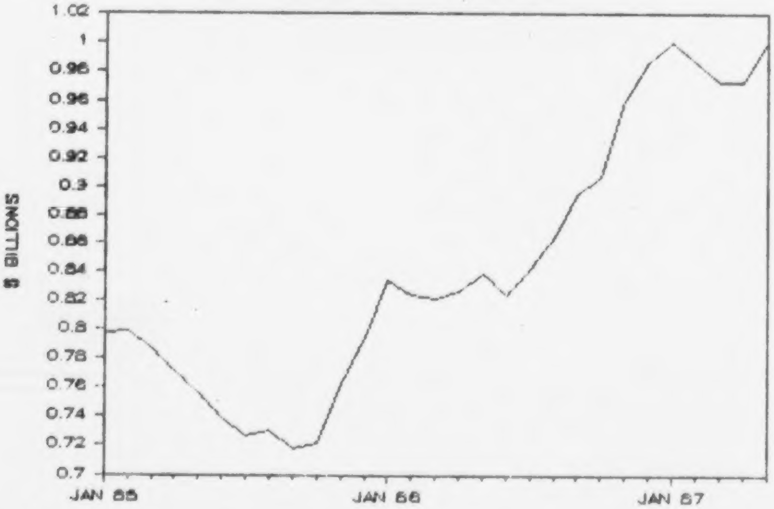
exports of merchandise to Japan remain significantly above the levels reached during the past four years.

U.S. EXPORTS OF MERCHANDISE TO JAPAN
(7 Month Moving Average)



Similarly, merchandise exports to West Germany reached their lowest point in October 1985 and have since risen by nearly 43 percent.

U.S. MERCHANDISE EXPORTS TO GERMANY
(7 Month Moving Average)



Finally, while U.S. imports from these two countries continue to rise, they are doing so at a much slower rate. Evidence of this is found in reports of significant declines in automobile imports as sales of imported cars have fallen faster than domestic car sales, losing market shares in the process.

During the last quarter of 1986, there were 3.6 million imported automobiles sold in the United States, accounting for 31 percent of total sales. But during the first three months of 1987, sales of imported cars had declined to 2.6 million, accounting for only 27.7 percent of the market.

Finally, there is also evidence of improvement in some of our more embattled industries. The textile industry, for instance, complained bitterly about the May surge in imports of its products. Yet, since the beginning of this year, exports of textile yarn have outpaced imports by a wide margin. The only area where imports have risen faster than exports has been woven textile fabrics, and that gap was only four percentage points. The steel industry shows a similar picture. Imports of iron and steel mill products rose by 26 percent since January, compared to a 27.6 percent increase in exports -- a small margin, but a positive one. The improving fortunes of the steel industry are corroborated by a report a couple of months ago that USX had made a shipment of steel to Japan and that the company's chairman had indicated that "the nation's steel industry is now in a good position to increase export shipments." Other industries that saw significant improvements in overseas sales include electronic products, aircraft, chemicals, and pharmaceuticals.

The evidence is clear; the trade picture has already improved markedly. The protectionists can no longer pretend that trade legislation is needed to reduce the trade deficit, or aid U.S. exporters, or protect domestic industries. Their confusion stems from the fact that they are looking at the wrong picture. The trade deficit has levelled off, exports are surging and import growth is slowing.

* * *

[1] Stuart Auerbach, "Trade Deficit Rises to $14.4 Billion," The Washington Post, July 16, 1987, page E-1.

[2] Keith M. Rockwell, "Trade Bill Still on Senate Floor," The Journal of Commerce, July 16, 1987, page 1.

[3] Richard Lawrence, "May Trade Deficit Deepens as Imports Set New Highs," The Journal of Commerce, July 16, 1987, page 1.

A3840-11.11F 10/87

U.S. Chamber of Commerce Economic Policy Division

Policy Working Papers

September 1987 Number 11

MOVING TOWARDS WELFARE REFORM

by
Rajni Bonnie Ohri
Economist

Once again welfare reform has become a major issue in American political life. In his 1986 State of the Union address, President Ronald Reagan drew attention to the problems of poverty and welfare in America by requesting the Domestic Policy Council to design a strategy for welfare reform, thus putting welfare back on the nation's agenda for the first time in a decade. A bipartisan consensus also appeared to exist for an historic overhaul of the nation's troubled welfare system. That consensus rests on three themes: giving states the flexibility to experiment with creative approaches to ending dependency; mandatory workfare requirements; and a crackdown on fathers who ignore their financial responsibilities.

Welfare, however, has always been an unpopular and divisive issue. Some blame poverty on failings of the economy or the educational system, others on deficient values and efforts of the poor. These disagreements have fueled arguments about what the government should do and should not do to reduce poverty, what the relative roles of federal and state governments should be, and what should be expected of welfare recipients.

Poverty Statistics Overstated

An analysis of welfare and poverty in America should begin with the fact that no two poor individuals or families face the same circumstances or have exactly the same needs. Any measure of poverty is necessarily arbitrary, and the number of people who are deemed to be poor depends on the yardstick used. Nonetheless, such measures are useful, both as guides to how economic hardship is distributed within the population and as a means of judging progress towards alleviating it. For over 20 years the official poverty measure has been based on a 1955 national Household Food Consumption Survey that judged each member of a family to be poor if the family had pretax cash income less than three times the cost of a nutritionally adequate diet. From this base, the federal government calculated how much income a family would require to meet all of its basic needs. The result is the "poverty level," which is adjusted to reflect family size, age and price level changes. For 1987, the Census Bureau established that a family of four receiving less than $11,200 in cash income ($7,133 for a family of two) was counted as poor.

Policy Working Papers are published by the Economic Policy Division of the U.S. Chamber of Commerce to inform the American public about relevant economic policy issues. These studies are intended as timely and thought-provoking contributions to the national debate about these issues which are of particular importance to the U.S. business community and the public at large. Permission is granted to quote from this report with appropriate attribution to the Economic Policy Division, Chamber of Commerce of the United States.

These poverty thresholds are then used to determine the poverty rate: the percentage of persons with incomes below the official poverty level. The poverty rate in 1953 was 26.2 percent, then fell sharply to an historic low of 11.1 percent in 1973, and stayed in the range of 11.2 to 12.3 percent through 1979. The largest one year increase in poverty occurred from 1979 to 1980--a 12 percent increase. In 1986, it stood at 13.6 percent (see Table 1).

TABLE 1

POVERTY DATA FOR ALL RACES 1959-1986

Years	Number Below Poverty Level (millions)	Percent Below Poverty Level
1959	39.5	22.4
1960	39.9	22.2
1961	39.6	21.9
1962	38.6	21.0
1963	39.4	19.5
1964	36.1	19.0
1965	33.2	17.3
1966	28.5	14.7
1967	27.8	14.2
1968	25.4	12.8
1969	24.1	12.1
1970	25.4	12.6
1971	25.6	12.5
1972	24.5	11.9
1973	22.9	11.1
1974	23.4	11.2
1975	25.9	12.3
1976	25.0	11.8
1977	24.7	11.6
1978	24.5	11.4
1979	26.1	11.7
1980	29.3	13.0
1981	31.8	14.0
1982	34.4	15.0
1983	35.3	15.2
1984	33.7	14.4
1985	33.1	14.0
1986	32.4	13.6

Source: U.S. Bureau of the Census, *Current Population Reports.*

As accurate measures of how many Americans are poor, the poverty statistics have major limitations that tend to overstate the incidence of poverty. Official poverty numbers do not include all income received by poor individuals such as noncash government benefits (Food Stamps, Medicare and housing subsidies). For the past 20 years, noncash benefits have multiplied, accounting for 76 percent of the value of all benefits (compared to 35 percent in 1964), amounting to annual expenditures of $99.8 billion for low-income Americans. In addition, assets are also not counted, therefore, someone who is unemployed for a year but still owns a home and has a large savings account is counted among the poor.

Official poverty statistics also compare pre-tax income with poverty thresholds based on after-tax incomes. The current treatment of taxes in measuring poverty fails to distinguish between the different resource needs of families with and without tax liabilities. For instance, two families with the same pre-tax incomes will not be equally well off if one has income from earnings that are subject to payroll and income taxes while the other has income from untaxed transfer payments. Finally, census surveys of income rely on voluntary responses and income is often understated. Nevertheless, while official statistics may overstate poverty, it is still clear that poverty and welfare remain a problem.

Rising Welfare Rolls

Since their inception, federal public assistance programs have stressed the importance of work that leads to self-reliance and financial independence. However, the evidence shows that far from succeeding in moving recipients off welfare and into self-sufficiency, public aid programs are laced with incentives which encourage long-term dependency.

Nearly one-quarter of U.S. families without parents at work are poor. By contrast, among families whose head of household works full time, only 4 percent live in poverty. The same is true of female-headed families, which are historically one of the poorest segments of society: less than one in ten such families remain in poverty if the mother works full time. Currently, the Aid to Families with Dependent Children program, the heart of America's welfare system, (AFDC provides cash assistance to low income single parent families, 90 percent of which are headed by females), supports 3.8 million of the 6 million female-headed families with children in the U.S. While AFDC is often depicted as a temporary relief program, the evidence proves otherwise: intermittent but prolonged welfare dependence is the norm for mothers on welfare. Since welfare payments are made only on the basis of children dependent on one parent, the AFDC program attracts women into single parenthood. Among women entering the welfare rolls for the first time, 70 percent remain for two years or longer; the average stay is nearly 7 years. Of the women currently on the welfare rolls, nearly two-thirds can be expected to remain on welfare for eight years or more, and the average period on welfare is 11.6 years.

In January 1987, the average AFDC benefit for a mother with two children and no other cash income was $354 per month. This ranged from a high of $749 in Alaska to a low of $118 in Alabama. And since 1970, AFDC benefits have kept pace with inflation in only 3 states--California, Maine and Wisconsin. Benefits have declined, in real terms, in all of the remaining states, and on a per capita basis, the average value of AFDC benefits has fallen by 16 percent since 1970. In addition, according to a recent Congressional Budget Office (CBO) study, as the number of female-headed households have increased, federal expenditures on AFDC have edged upwards, from $7.8 billion in 1982 to $9 billion in 1985.

Today's Welfare System

While it is essential that welfare assistance be provided for the poor through categorical programs, a major problem with the current system is that 59 welfare programs are scattered over several federal agencies. As a result, total spending on welfare assistance is virtually unknown. Indeed, some estimates claim that federal and state governments spent over $132 billion in fiscal year 1985. But when forty other federal low income assistance programs are added, total spending, including loans, came to over $150 billion. Adding matching funds increased the total to over $160 billion. As Jonathan Hobbs points out in the book *Agenda 83*: "Welfare costs are spread throughout the budget, in hundreds of line items funding specific kinds of benefits...In fact, there may be several duplicative or complementary benefits from other programs available to the same group of recipients."

The 59 major federal programs comprise a centralized welfare system that is inscribed in over 6,000 pages of federal laws managed by eight major federal departments, through numerous agencies in the 50 states, and by thousands of welfare workers. The Census Bureau estimates that over 52 million Americans, nearly 20 percent of the population, benefit from some welfare program during a single year. Clearly, the large array of programs makes it possible for those knowledgeable of the system to benefit significantly and have a higher real standard of living than many who work.

Most of the spending on welfare is concentrated within five key programs: AFDC, Supplemental Security Income, Medicaid, Food Stamps and Housing Assistance. Of the main federal programs, 10 provide cash assistance, totalling $32.3 billion. The largest of these programs, at $14.8 billion is AFDC, which pays monthly benefits to nearly 4 million families consisting of 11 million persons; this is followed by Supplemental Security Income (SSI) which provides $10.9 billion to over 4 million aged, blind or disabled persons.

The noncash benefits consist of three major programs: six health programs, totalling $48.6 billion, where Medicaid, at $41.2 billion, is the largest and fastest growing low-income program serving over 23 million persons; twelve food assistance programs which spend $20.4 billion, with Food Stamps benefiting 20 million persons every month at an annual cost of $12.5 billion; and nine housing assistance programs which total $13.7 billion a year. In addition, nine job training programs total $4 billion a year, and eight education programs spend $8.3 billion annually. The remaining low-income programs each spend over $20 billion and provide a variety of services.

Creating the System

But America's welfare system was not always so elaborate and centralized. Only a few decades ago the federal government played a small role in providing public assistance. But the Depression of the 1930s changed all that. The Social Security Act of 1935, which contained the first major federal public assistance programs, forced the government to provide social insurance for the elderly and the unemployed. In addition, the Act initiated the joint federal-state programs of Old Age Assistance, Aid to the Blind and Aid to Dependent Children. These programs retained a conceptual link to the ideal of self-reliance by directing aid to those who could not provide for themselves--the aged, the disabled and children deprived of the support of a parent.

In the 1960s, federal welfare spending expanded dramatically during Lyndon Johnson's War on Poverty. The Economic Opportunity Act of 1964, the centerpiece of the War on Poverty, introduced an array of new public programs--education, training and service--designed to attack the root causes of poverty. Later, more programs--Medicaid, Food Stamps, and Housing Assistance Payments--expanded assistance further. Virtually anyone with limited income could qualify for some sort of public assistance. Accepting welfare payments clearly became a more attractive offer than taking a job. Thus, the expansion in noncash benefits created a system that would maintain large numbers of persons below the poverty level, never raising them above it.

These low-income benefit programs also represented a significant shift in the nature of public assistance. Cash benefits began to be replaced by food, medical care, housing and other noncash benefits. In 1960, 75 percent of all welfare was in the form of cash; by 1985 only 24 percent was in that form. This shift is considered important because non-cash benefits diminish personal choice and self-responsibility among welfare recipients, forcing them to become more dependent on the rules and decisions of others. In addition, non-cash benefits are not counted as income in the measurement of poverty rates, thus understating the poverty rate.

Welfare Spending Skyrockets

The War on Poverty also produced an important shift in the public perception of welfare. What had been viewed as public aid began to be seen as public entitlement. And while the programs still invoked self-reliance as an ideal, they introduced rules that undermined it in practice. As more Americans became eligible for welfare, federal spending skyrocketed, from $21 billion (in constant 1985 dollars) in 1960 to $62.2 billion a decade later, $121.8 billion in 1976, $132.2 billion in 1985 and about $140 billion in 1986.

Between 1960 and 1985, federal and required state spending on major federal welfare programs grew by 525 percent. And cash assistance rose by 105 percent in real terms, while noncash benefits soared by 1,760 percent. This explosion in welfare spending continued through 1976, then stabilized and continued to rise at a slower pace in the 1980s. While outlays for some individual programs have fallen since 1980, the real growth in total benefits has continued. Spending has grown, in real terms, by 7.6 percent a year since 1960 and one percent per year since 1981.

This growth momentum was primarily the result of Congress' liberal expansion of public assistance programs during 1970-75. This six year period contained two severe economic recessions and intervening years of rapid inflation. The low-income programs unleashed at that time created a spending momentum that would continue until the early 1980s. In each recession, program eligibility was liberalized and benefits increased. This was done, in large part, by transforming discretionary programs into open-ended entitlement programs. Between 1970 and 1975, six of the nine nutrition programs, including Food Stamps and the school lunch program, were converted to entitlements and indexed to inflation. And, in the case of Medicaid, the entitlement was expanded to include services provided by intermediate care facilities; this expansion changed the nature of Medicaid, and accounted for 40 percent of the tripling of Medicaid costs from 1972-1981. Overall, entitlement programs accounted for 77 percent of the total growth in low income benefit costs during the period 1970-81.

Welfare Creates Poverty

Work-related programs for recipients of public assistance (workfare)--including job search assistance, training and education, unpaid work experience--have received considerable attention in recent years. Perspectives on the proper relationship between work and welfare have changed substantially. For instance, Title 4 of the Social Security Act of 1935 contained no mention of work for welfare recipients. But by 1962, the Community Work and Training Program (CWTP) allowed states to require work from AFDC recipients in return for their benefits. Only 13 states participated in the program and its authorization expired in 1967. Again, this was a result of the welfare programs of the 1960s which caused two serious problems. First, the offer of welfare payments to those people who did not work created a disincentive to work. And, the AFDC program encouraged fathers to leave home, since benefits are paid to female head of households.

Because of the work disincentives inherent in the system, the Work Incentive Program (WIN) was enacted by Congress to provide welfare recipients with an incentive to obtain work. The federal government provided 90 percent of the funds for WIN, and states paid the remaining 10 percent. Before WIN, each dollar earned meant welfare was reduced by a dollar, thereby putting a 100 percent tax on money earned by working. Thus, an "earnings disregard" was included in WIN wherein the recipient could disregard the first $30 of their earnings plus one-third of the remainder of their earnings without a reduction in welfare benefits. The intent was to induce AFDC recipients to work, but the actual effect was to induce families with relatively higher incomes to remain on welfare. During the first 21 months of the WIN program, the nation's welfare rolls swelled by 641,000 persons and only 13,000 Americans left welfare because of the program. And in 1985, it is estimated that WIN moved only 130,000 people off welfare, or about one percent of those on AFDC.

Many studies have shown that high AFDC benefit levels discourage work, and "earnings disregards" are not an effective way of encouraging work.

Lowell Gallaway and Richard Vedder of Ohio University have put forth the theory that as welfare expenditures increase, two results occur: for some people there is an income enhancing effect that tends to move them out of poverty; for others there is a disincentive effect which causes them to reduce the amount of their work effort and earned income, shifting them below the poverty level of income. The greater the availability of welfare benefits, the stronger will be the disincentive effects. A number of studies in the *Journal of Human Resources* and the *Monthly Labor Review*, using individual rather than aggregate data, confirm the importance of disincentives. Perhaps the most significant are the various Income Maintenance experiments that have been funded by the federal government. These were designed to specifically explore the nature of low-income people's labor market responses when placed in a situation where they are receiving direct money payments that do not depend on the amount of income they earn through work activity. The results show that direct money income payments tended to reduce the volume of work effort of the participants.

Taken collectively, these various analyses make a compelling case for the argument that welfare benefits are creating incentives for low income people to reduce their work effort. Welfare is creating poverty, not eliminating it.

Further Workfare Incentives

Legislation enacted in 1981 and 1982 authorized states to establish alternatives to WIN and to require, at each state's option, that certain registrants participate in job search assistance and workfare. As with other AFDC administrative costs, the federal government reimburses states for 50 percent of the costs of these activities. In response, many states have experimented with new ways of providing work-related activities to AFDC recipients.

In effect, the Reagan administration introduced key changes in welfare policy through the Omnibus Budget Reconciliation Act of 1981 (OBRA), which essentially eliminated the WIN earnings disregards and caused welfare rolls to shrink. OBRA established three workfare policies: (1) the WIN Demonstration program, where AFDC beneficiaries may be required by the state to participate in full-time work programs, thus giving states more flexibility in designing and operating their welfare work programs; (2) the Community Work Experience Program (CWEP) where a welfare recipient can be required to participate in workfare permanently but the number of hours worked per month is limited and often less than 20 hours per week, thus requiring states to operate mandatory work programs for AFDC recipients; (3) the Grant Diversion program (wage supplementation) where the recipient's welfare grant is diverted to a private employer to pay for up to half of the recipient's wage.

Welfare mothers with children under age six generally are exempt from work requirements, although 11 states have obtained waivers from federal rules to make participation mandatory for AFDC mothers with children over age three. About 39 states currently operate new work programs under the OBRA provisions. These programs, widely acclaimed as successful, show that low budget job search assistance, and training and community work experience projects can increase the employability and earnings of some welfare recipients. A recent CBO study found that nearly all work-related programs increase the average earnings of economically disadvantaged female participants by moderate amounts. Evaluations by the Manpower Demonstration Research Corporation (MDRC) of workfare experiments in Arkansas, California, Maryland, Virginia and West Virginia indicate that carefully designed work-related programs for AFDC recipients can be successful.

Massachusetts' Employment Training program has been the most ambitious welfare to work transition program. And Illinois has introduced Project Chance, a job and training program aimed at the 120,000 female welfare recipients in the state who have children under age six. North Carolina requires a "social contract" between recipients and case workers to guide the transition to full-time employment.

The costs to governments of operating work-related programs for welfare recipients are offset to some extent by savings generated from reduced outlays for AFDC, Medicaid and other transfer programs for the participants. According to MDRC, the findings from recent state workfare demonstrations show that participants reduced their use of transfer payments and increased their tax payments by enough to offset operating costs within five years. However, workfare programs can also swallow up federal funds without producing any noticeable results. Evidence by Jean Grossman and Audrey Mirksy in *A Survey of Recent Programs Designed to Reduce Long-Term Welfare Dependency* shows that the workfare programs of the late 1970s cost $26,000 per participant but produced no greater results than the current job search programs costing a few hundred dollars.

Welfare Reform Legislation

In considering welfare reform legislation, Congress must address several issues. Society's consensus should establish national goals for welfare assistance, such as access to adequate housing and education. States should be required to meet these goals through effective welfare assistance programs; it is states, not the federal government which have the primary governmental responsibility to ensure that adequate welfare programs are available. Congress might require states to provide specific types of activities, such as funds for education and training, or leave all decisions about workfare activities up to the individual states. For instance, Stuart Butler of the Heritage Foundation found that replacing in-kind services with vouchers turns poor people into powerful consumers and forces private providers to become more efficient. Food stamps and student loans are examples of existing voucher programs. Welfare policies should also be more employment-oriented. Welfare reform should emphasize tighter eligibility standards that encourage individuals to take the jobs available to them.

Current welfare reform bills in Congress require the states, for the first time, to set up work, job-training and other proposals to help single parents shift from the AFDC welfare rolls to payrolls. The House bill would provide federal financial incentives to spur states to raise welfare benefit levels, a principle which is endorsed by Senator Moynihan (D-NY), the chief sponsor of the Senate legislation. Yet higher benefits simply make work even less attractive and encourage recipients to become more dependent. Indeed, during the last decade, the number of children in poverty in states with low AFDC benefits has fallen, while the number of poor children in high benefit states has increased significantly. Robert Rector of the Heritage Foundation claims that raising welfare benefits by 20 percent nationwide could expand the AFDC population by one-third, adding one million families to the welfare rolls, increase the number of female-headed families by 20 percent, and increase the divorce rate among young families by 66 percent. Another idea in the House proposal is to require all states to establish AFDC for intact two-parent families (AFDC-UP). But including two parent families in AFDC makes more families accustomed to welfare dependency.

In addition, the House legislation and Senator Moynihan's proposal does not include the decentralization of the welfare system, and limits states' ability to devise their own experimental welfare programs. Moreover, the costs associated with both bills would be appreciable--the House bill raises federal spending by $5.2 billion over 5 years; and the Senate bill raises it by $2.3 billion. Neither bill, however, contains a national minimum benefit level for families receiving AFDC benefits to overcome large disparities in benefits between states.

Senator Moynihan's welfare reform bill also includes provisions such as providing public funds for education and training for welfare recipients, requiring absent parents to support their children, and forcing women on welfare to take part in a job search program unless they have a child under three years of age.

The House Republican alternative, sponsored by Congressman Hank Brown (R-Colo.), offers a welfare plan that would cost the federal government $1.4 billion over five years. The principal advantage of Brown's proposal over the Democratic bills is that it does not increase benefits. The total federal appropriations for the training and placement programs, plus costs of necessary child care, would be limited to $500 million for the first year, and after that to such sums as Congress appropriates. In addition, Congressman Brown's bill reduces barriers to work by strengthening employment, training and child care opportunities for AFDC recipients; it tightens the nation's child support laws; it provides flexibility to states to reduce administrative costs and consolidate programs; and it provides federal assistance to states that succeed in placing recipients in the labor force.

The Administration's current welfare program--the Greater Opportunities Through Work program (GROW)--is its most ambitious to date. GROW would lower the exemption from work activities, which currently applies to mothers with children under six years of age, to those with children under six months; it would mandate large-scale participation in work activities by welfare beneficiaries in all states; and would provide uncapped supporting federal funds for job search and workfare, job-related expenses and child care at a 50 percent matching rate. Finally, the Child Support Enforcement Program will seek increased payments by absent parents in support of their children.

In each of these proposals, the net impact on the federal budget would depend, in part, on how many states respond to the requirements and incentives established and on the extent to which the program costs are offset by reductions in outlays for AFDC and other transfer programs. Increasing the matching rate or the range of eligible activities could significantly increase federal outlays, creating larger budget deficits in the near future.

Conclusion

Without question, the need for extensive and substantive welfare reform is long overdue. The tragic result of the government's well-intended but misdirected efforts has been the creation of a welfare "subclass" which confirms the fears of President Franklin Delano Roosevelt when he remarked in 1935 that "continued dependence upon relief induces a spiritual and moral disintegration fundamentally destructive to the national fiber...(It is) a narcotic, a subtle destroyer of the human spirit."

The current welfare system provides handouts that harm the poor. By removing the normal obligation to support self and family, welfare undermines the personal discipline needed for work and participation in society. The welfare programs have also had a disastrous effect on two fundamental American values: the work ethic and family unity. Clearly, the government has a moral responsibility to correct the defects in its current welfare policies that destroy the incentive to work for those that possess the ability to work. Workfare, by restoring the welfare recipient's obligation to contribute to his own support and that of his family's is not only fair to the rest of society, it is essential to the well-being of the individual.